

"We want to do this. Is it fundamental—may we do it without going to our stockholders?"

Under section 17 (g) the Commission asks for authority by rule, regulation, or order, to require that an investment company utilize the services of a bank as custodian, and that officers, and so forth, and so forth, be bonded by a fidelity insurance company, in such minimum amount as the commission may prescribe. The provision should be heartily endorsed by banks and insurance companies. The S. E. C. will be a prolific source of business for these concerns, at the expense of the stockholders of investment companies. This is peculiarly an internal matter for the management and for the stockholders. At the very most, the requirement should be, instead of permitting the S. E. C. to decide the matter, to require it to be submitted to the shareholders with information on the need of the proposal and with full data as to its cost. Personally, I believe in the use of a trustee or custodian, and in the bonding of employees, but that is a matter that each company should decide for itself and should not be the subject of S. E. C. discretion.

Senator HUGHES. If you will pardon me right there for a moment: As I understand you, you are opposed to the power in the S. E. C. to designate depositories or to require that funds be deposited with a bank or certain banks?

Mr. MYERS. That is perfectly correct.

Senator HUGHES. And you think that power should be left entirely to the investment trusts?

Mr. MYERS. I tried to make this point: That if the S. E. C. should find in a given instance it is desirable that a given company should utilize the services of a corporate trustee or a corporate custodian or a bank trustee or a bank custodian, the very most that the S. E. C. should be permitted to do is to require a submission of the question, with data as to the reasons, and as to the cost thereof, to the stockholders of the company for them to decide how they want their assets handled.

Under section 18 (d) the commission asks that, upon application by any holder of any security of an investment company, it be required, and on its own motion be permitted, to make the company take such steps as are necessary or appropriate "to effect an equitable redistribution of voting rights and privileges among the holders of the outstanding securities." This is to take place after 2 years. Note that the application may be made by any holder of any security—a broad invitation for strike actions against investment companies with nonvoting securities. The provision apparently was intended to apply only to investment company systems and not to individual companies. But I believe, as, I think, does Mr. Schenker, it is possible so to interpret it that it will affect any company with nonvoting securities outstanding. I have no doubt that some attempt will be made by the instigators of strike suits to make it so apply.

This subject has been adequately discussed by representatives of the closed-end companies, and all I want to do in this connection is to point out that in many cases the question of the vote is something that is covered by the charter of the investment company concerned, and I cannot conceive of a method by which the S. E. C. can effectively make the holders of voting control voluntarily vote to amend the charter of the company in order to accomplish this equitable redis-

tribution of voting rights. But the subject, as I say, I think has been adequately covered.

The provision gives the S. E. C. the right to abrogate the terms of the contracts under which all senior securities were issued and are now outstanding, and, what is worse, the S. E. C. asks the right to enforce, in the face of those contracts, the S. E. C.'s own idea of what is an "equitable redistribution of voting rights." It involves matters that are embodied in corporate charters, changeable only by stockholder action. The S. E. C. apparently expects the holders of the voting stock voluntarily to give up a portion of their voting rights. But suppose they won't? How will the S. E. C. make them vote according to its idea of what is equitable?

Before taking up the authority of the S. E. C. relating to dividend payments, I should like to point out that Mr. Smith gave testimony about what he called dividends paid out of capital. He gave the impression that section 19 (a) of the bill dealt with the payment of dividends out of capital.

The provision goes far beyond this. I could understand a restriction merely against distribution of capital in the form of dividends, but this section puts the same restriction upon the payment of dividends out of profits.

If a company has sold securities at a price higher than cost, it realizes a profit by so doing, and this bill actually provides that the net profit so realized may not be distributed except under the same restrictions that apply to distribution of capital. This is in the face of a provision in the revenue act that a mutual investment company must distribute to stockholders at least 90 percent of its taxable income, or lose its tax advantage. Net profit realized as described, is, of course, taxable.

Section 19 (b) of the bill goes even further: It prohibits the payment of any dividend, irrespective of its source, if the company has senior securities outstanding, unless certain asset coverages exist. The coverage required in connection with senior stock is 200 percent, but the Commission asks for the right to increase this coverage up to 300 percent or to reduce it to 150 percent. If the senior securities consist of evidences of indebtedness, the asset coverage is 300 percent, which the Commission is permitted to increase to 400 percent or to reduce to 200 percent.

It is difficult to conceive the basis for requiring such large asset coverage for senior securities before dividends can be paid out of earnings, net profits and earned surplus. Were the prohibition on distribution of capital in the form of dividends, it would be more understandable, but to prohibit dividends out of income and profit after interest charges and other expenses have been met, seems more than a trifle harsh. The concession that, under this bill senior securities, although prohibited in the future need not now be retired, is of no practical value if the bill, in effect, prevents the payment of dividends on the common stock. However, even if one should feel the prohibition desirable, it goes beyond reason to permit the S. E. C. to stiffen the basic coverage figures. Any company would be better off knowing what it had to face with certainty, without the fear that its policies might be interrupted.

Here, again, there is too much opportunity for the S. E. C. to establish by dictation its own ideas relating to dividends. This is some-

thing that should first be covered by the terms of the contract under which the senior security is issued, and secondly by the management of the company exercising its discretion in this purely internal company policy.

Under section 22 the S. E. C. asks that an open-end company be prohibited from selling, redeeming, or repurchasing any of its securities except at a price bearing such relation to the asset value as the commission shall prescribe by rule, regulation or order. The stated purpose for putting such power in the Commission is the elimination of dilution or accretion in the value of other securities of the company as a result of such sale, redemption or repurchase. This would mean that the Commission would obtain complete power over all methods of open-end companies of determining the asset value, the sale price, the bid price, or the redemption price of every security issued by any such company. This includes the right of the Commission to insist that its own methods be used, whether they are practical for sales purposes or not.

This was a subject discussed by Mr. Traylor, and I think completely discussed. I agree with everything he said in that connection.

In the same section the Commission asks power, if it "has reason to believe" that a security of an open-end company is being offered at a price which includes "an unconscionable or grossly excessive sales load," to hold a hearing and to require the company to show cause why the load should not be prohibited. And if, after the hearing, the Commission thinks this is so, the Commission may issue a so-called cease and desist order. The bill gives certain guides to the Commission in determining whether a load is excessive. There might be little real objection to these, even though they enable the S. E. C. to impose different standards on different companies. But the section then asks that the Commission be allowed to give attention "to such other factors as are relevant in the particular proceeding." This adds immeasurably to the scope of the commission's authority. There is, of course, basic objection to the idea that profit in sale of investment-company securities—the sales load or commission is the profit—should be put under the control of a government body. Remember that the amount of the sales profit is fully revealed in the prospectus of the company under the Securities Act of 1933. The S. E. C. should not disturb a completely publicized selling commission. The amount is fully controlled by competition and cannot be successfully influenced by artificial means. This business is not a quasi-monopoly, and to adopt this provision might be the first step in Government control of the profits of all business.

The control over the distribution of shares of open-end companies has been emphasized, since it is they who are currently selling securities. But some control extends to closed-end companies, which, under section 23, are brought under the domination of the S. E. C. by giving it power to make rules—

to prevent or limit issuance * * * at a price below the current asset value.

The securities of a great many closed-end funds have a current market below asset value and, until this market situation is corrected, the Commission would be permitted to ban absolutely the sales of stock by such closed-end companies.

I omit discussion of the power the Commission asks over the form and content of prospectuses, over unit-type trusts, periodic-payment

plans, and face-amount certificate companies, and go directly to section 30, which relates to periodic reports. The apparent reasonableness of the section is destroyed when it is realized that the reports may be required not only from the company, but from the manager, investment adviser, underwriter, depositor, and distributor.

A distributor, as I understand it, means every dealer in the country who sells a share of stock.

They may include "such annual, semiannual, quarterly, and other periodic reports" as the S. E. C. may ask and the filing of "the minutes of such directors', stockholders', and other meetings", as the Commission may prescribe.

The Commission may require, if it sees fit, that any or all of this material filed with it also be sent to stockholders.

No one has advocated complete disclosure to stockholders more strongly than I, and my companies go the limit in this direction, but there should be some limit on what the S. E. C. may require to be furnished to stockholders.

Section 30, paragraph (a) requires every company, underwriter, broker, dealer, adviser, and so forth, to make up and keep, for such periods as the S. E. C. may prescribe, such accounts, cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may require.

Paragraph (b) states that all records thus required to be kept, or which may be kept voluntarily, are subject to periodic, special, and other examination by the Commission or any representative of the Commission. Under this provision the S. E. C. will always be at the elbow of every investment-company officer and employee.

Paragraph (c) gives to the Commission—in case it hasn't already been given the authority—the power at any time to make an examination of all the affairs of an investment company. This repeats the wide latitude just described.

Paragraph (d) covers actual accounting, giving the S. E. C. the power we have heard about to establish uniform accounting methods. It covers all possible transactions and at first blush sounds reasonable. But in paragraph (e) we find that the S. E. C. may prescribe the account in which any item whatsoever shall be entered and the manner in which the entry may be made; to require that any entry be modified or supplemented, and to prohibit the keeping of records in a manner other than that prescribed by the Commission.

On top of all this, under section 32 relating to auditors, which are voted upon by stockholders, the S. E. C. may prescribe the minimum scope of, and the procedure to be followed in, any audit. This is repeated in section 30 (a) where it is required that financial statements filed with the Commission be audited and be made and filed at such time and in such form or detail as the Commission shall prescribe. Then independent auditors must keep "reports, work sheets, and other documents and papers" and make them available to the Commission or any representative. The company and its stockholders pay the auditors, but the S. E. C. tells them how to do their work and insist that every detail of that work, no matter how preliminary, be made available to the S. E. C. Work sheets often contain material which is never even seen by the client. They have always been regarded as the property of the auditor rather than the client. The investment-trust bill thus assumes regulatory power over even the

independent auditor who works for an investment company. I hope, before these hearings end, some accountant or association of accountants will express an opinion on this.

Under section 36, the S. E. C. gives itself full and unrestricted power to make rules "necessary or appropriate" to carry out the bill. The rule-making authority over investment companies is as full and complete as human ingenuity can make it. Judge Healey's "rubber" has been stretched to cover the business completely.

In section 38, and this is the last section I intend to discuss, we find the usual authority for fishing expeditions, giving the Commission discretionary power to investigate anything it deems necessary or appropriate in order to (a) determine whether any person has or is about to violate the law; or (b) aid in its enforcement; or (c) to help in making rules; or (d) to obtain information to serve as a basis for recommending further legislation.

I should like to point out, too, that this continued investigative authority, which I believe was doubtful under the Public Utility Holding Act insofar as it applied to investment advisers and investment counselors, is now cured and the extended authority now specifically applies to a continuance of the investigation of investment advisers and investment counselors, since section 38 is incorporated by reference in the title of the bill.

The 4½-year study of investment companies—the cost of which was asked Mr. Schenker by Senator Townsend during the early days of these hearings, and which has been stated to be \$581,000 up to April 1, not including another half-million cost to the trusts—is authorized to continue indefinitely. The section states:

The Commission, in its discretion, may investigate any facts, conditions, practices, or matters, which it may deem necessary or appropriate * * * in obtaining information to serve as a basis for recommending further legislation concerning the matters to which this title relates.

This continued investigation now expressly applies to investment advisers, since this section is incorporated by reference into title II of the bill.

In conclusion. It has been impossible to consider all of the fifty-odd discretionary powers asked for by the S. E. C. in the bill. Only a few of the more significant could be treated at all, and the time available has not permitted a full discussion of any one of them. The omission of any provision does not mean there is no opposition to it.

I realize, of course, that many of the discretionary powers given to the S. E. C. in this bill would be burdensome to investment companies only if the S. E. C. should act arbitrarily or unreasonably. I don't say they will. Frankly, I don't know, whether the present Commission would or not, the Commission is subject to change in its personnel and necessarily, in its investment philosophy. The point is that the S. E. C. has the power to be unreasonable. That power should be minimized.

I thank you for your attention.

Senator HUGHES. Might I ask you a question right there?

Mr. MYERS. Certainly, Mr. Chairman.

Senator HUGHES. Am I to understand that your objection goes to all discretionary powers provided for in this bill?

Mr. MYERS. That is too broad a question to be answered in a word. I have already taken the position that there are necessarily dis-

cretionary powers which an administrative body must have for efficient administration of a bill of this character.

But the difference is between that kind of discretion and the wide-open discretion that this bill, in some fifty instances as opposed to some thirty instances of what I call administrative discretion, gives to the S. E. C. that cover formation, operation, management policies, and so forth, of investment trusts that take them from their birth to their death.

Senator HERRING. Mr. Myers, as I came into the room you were discussing the subject of payment of dividends. You do not wish to be understood as objecting to the prohibition of payment of dividends from capital, do you?

Mr. MYERS. Senator Herring, there is a good deal to be said on both sides of that question.

Senator HERRING. I am speaking of capital now and not capital gains.

Mr. MYERS. So am I, sir. I think there is something to be said for the theory that in many instances continuity of income is desirable. Let us assume that a company has a substantial amount of realizable capital gains. It is at a time when the management of the company thinks it would be desirable to hold their invested position rather than to sell in order to realize those gains to stabilize the dividend rate. That is, a dividend rate well within what experience indicates the company can pay. I think in a situation like that it is perfectly proper for a company, if I might use the expression, to borrow from its paid-in surplus account—subject, of course, to State law restrictions on the extent to which paid-in surplus can be used. There are such State law restrictions, but to borrow from its paid-in surplus for the purpose of stabilizing dividends.

I know of one situation where that took place and where by the end of the year realizable profits had come into the till to an extent sufficient to enable the company to pay the money back.

Senator HERRING. Oh, yes; if they guess correctly, all right.

Mr. MYERS. I think a great deal depends upon whether the stockholder knows what he is getting. It will be contended, I feel sure, that many stockholders do not know, even though you tell them, that because a payment comes in it is from, shall we say, paid-in surplus or capital surplus. I think, however, that many stockholders do know it, and I know that where paid-in surplus has been so used for dividends the effort of the S. E. C. has been to advise stockholders of that fact.

There is much to be said on both sides of the question. I know that there are arguments on the other side, and I am perfectly willing to give weight to those arguments. It is not a clear question and is not something I would be willing to answer categorically. I do say, however, the prohibition in this bill which puts restrictions on the payment of realized profits, on capital gains, is fundamentally wrong.

Senator DOWNEY. To what extent can investment trusts have debts?

Mr. MYERS. To the same extent, I think, as any corporation, Senator Downey. It is determined purely and simply by the powers that a corporation has under its charter to borrow money, through the issuance of debentures, or bonds, short-term loans from banks, and so forth. Most open-end funds have distinct restrictions on the

amounts borrowable. In the case of Affiliated Fund, Inc., one of the companies I am interested in, there is no power to borrow money except through the issuance of debentures, and the debentures are issued under a highly restrictive trust agreement, and I mean trust agreement.

However, my associate, Mr. Lord, who follows me, will discuss the debenture end of our company. We are not permitted under any circumstances to issue debentures of more than 66⅔ percent of the total assets of the company, and as a matter of practical control and other guides it is very seldom that we can get above 40 percent.

Senator DOWNEY. Would the payment of dividends from your surplus capital ever act prejudicially to the rights of creditors?

Mr. MYERS. Under our constitution, definitely and emphatically not.

Senator DOWNEY. It could not?

Mr. MYERS. All the assets of our company are pledged to secure, first, payment of the debentures and, secondly, to be devoted to the interests of the common-stockholders. There is a provision, which we now know of as the touch-off clause, which requires that the debentures be liquidated and called, should the assets ever fall below 125 percent of the outstanding debentures. There are other limitations, as a matter of practice; I need not bore you with them; but it would mean that it would be long before the touch-off clause would be invoked, that assets would be liquidated and debentures protected.

In my judgment, it is not possible or legal for the payment of dividends from capital and paid-in surplus ever to act prejudicially to the payment of the debentures.

Senator HUGHES. Am I wrong in stating that when you pay off your stockholders, in the way of redemption, you reduce the security of the creditors?

Mr. MYERS. Of the debenture holders?

Senator HUGHES. Yes.

Mr. MYERS. Naturally. I wish to point out to you, however, that the debentures themselves, in our company, are redeemable. The holder has the same right. Naturally, if a stockholder redeems his securities, the total assets are reduced by that much, and consequently the coverage is that much decreased. However, that is protected against by the operations of the touch-off clause and the other restrictions. You cannot get to a point below which the debenture holders will be harmed. It cannot be done.

Senator HUGHES. In other words, there will always remain enough to redeem and pay off the debentures?

Mr. MYERS. Any time when the assets get below 125 percent, the trustees are called upon to liquidate and to pay off debentures.

Senator HUGHES. Is that provided for in your charter?

Mr. MYERS. That is in the trust agreement under which the debentures are issued. It cannot be changed.

Senator HUGHES. Yes.

Mr. MYERS. That is all I have to say at this time, Senators.

Senator HUGHES (presiding). Very well; we are glad to have heard you.

Mr. MYERS. Mr. Chairman, I should like to present my associate, Mr. Lord, who is president of Affiliated Fund and is also president of Lord, Abnett & Co.

Senator HUGHES (presiding). We are glad to hear you, Mr. Lord.

STATEMENT OF ANDREW J. LORD, PRESIDENT, LORD, ABBETT & CO., INC.; PRESIDENT, AFFILIATED FUND, INC., NEW YORK CITY

Mr. LORD. Mr. Chairman and Senators, my name is Andrew J. Lord. For the past 21 years I have been continuously engaged in the investment business. For the past 10 years I have been president of Lord, Abnett & Co., Inc., which is identified with several investment companies, the largest of which is Affiliated Fund, Inc., of which I am also president. Affiliated Fund, Inc., has assets of approximately \$24,000,000, and is the largest open-end company in this country which employs senior capital.

I am appearing in opposition to the investment-trust bill.

Senator HUGHES. Will you explain that now? I do not claim to know all about investment companies or very much about them.

What do you mean by senior capital?

Mr. LORD. Senior capital is the capital senior in rank and priority to common stock. In our case it represents the one class of debentures. Our capitalization is made up of the senior capital of debentures, followed by the common shares of the company.

Senator HUGHES. I want that statement for the record, of course.

Mr. LORD. Yes, sir. Other representatives of the investment trust industry have already stated their views and, I believe, have set forth completely why the industry as a whole is so definitely opposed to this bill as drawn, in spite of the fact that many of us would favor constructive, realistic, and uniform regulation.

My purpose in requesting Senator Wagner's permission to appear is more specific: To set forth our basic objections to section 18 of the bill, which—as you gentlemen will recall—limits capital structures in the future to simply one class of stock and, therefore, prohibits the future issuance of senior securities.

I am not here to discuss complex forms of capitalization such as Mr. Schenker doubtless had in mind when in his testimony he referred to "class A common, class B common, class A preferred, class B preferred, debentures of 1954, and so on."

Senator HUGHES. Well, we have all those in the companies. That seems to be a fashion that has grown up.

Mr. LORD. As I say, I am not here in support of that form of capitalization.

However, I cannot agree with the theory that senior securities should be prohibited, per se. We believe that the investor should have the opportunity to decide for himself after the full disclosure, now required under the Securities Act of 1933, whether or not he wishes to purchase shares in a trust with senior capital carefully limited by the restrictions of a trust indenture.

There is no fundamental difference between this form of capitalization and that generally followed by American business today. Many of our most important corporations employ senior capital for the benefit of the equity holder. To name just a few, the Anaconda Copper Co. has senior securities to the extent of \$48,000,000. Bethlehem Steel has \$185,000,000 of funded debt, in addition to \$116,000,000 of preferred stock. Firestone Tire & Rubber has \$95,000,000 of senior securities; National Dairy Products, \$67,000,000; Standard Oil Co. of New Jersey, \$294,000,000; and United States Steel—Mr. Schenker, to the contrary notwithstanding—has a total funded debt of

\$246,000,000, including \$100,000,000 of debentures of the parent company.

To be sure, the bill makes no provision for disturbing the present capital structure of investment companies; but we believe it goes beyond the bounds of good judgment, in completely prohibiting the future issuance of senior securities.

Does the Congress wish to tell the American public that they cannot buy the senior securities of an investing company or the common shares of such a company? No law should be enacted that would flatly prevent the borrowing of money for possible greater gain.

It has properly been required that the buyer of investing company shares be given all the facts. Such being the case, the investor should decide for himself whether he wishes to take the risk of greater loss for greater gain. No one should take it upon himself to say that the shares of a soundly constructed and well-operated investing company with certain prescribed amounts of senior capital may not be purchased by investors, in the face of the fact that the shares of a highly speculative promotion may be registered with the Securities and Exchange Commission and sold with no restriction beyond full disclosure.

One of the problems facing the country today is the lack of "venture capital." Through the issuance of senior securities in an investment trust, capital seeking the safety and stability of conservative bonds or debentures finds its way into the purchase of common stocks in the trust's portfolio. This transformation of "safety capital" into "venture capital" is a factor of economic importance generally overlooked in a discussion of investment trust capitalization.

Time does not permit a detailed discussion of the criticisms of the Securities and Exchange Commission with respect to the dangers and abuses of senior securities in the various companies studied. In a recent section of the report of the investment trust study, being chapter 5, dealing with "problems in connection with the capital structure," 369 pages are devoted to "multiple security" companies. Of these, only 4 pages cover "bonds or debentures in open-end companies." Nearly all of the criticisms made, we believe, have been met in the capital structure of Affiliated Fund, Inc.; and those that are not covered by already existing provisions could readily be covered in the kind of a bill which we envision.

There is one thing, and one thing only, that can prevent these problems from being solved to the satisfaction of all concerned: the unwillingness of the Securities and Exchange Commission to work with representatives of open-end companies with this objective. Mr. Smith has stated in his testimony that such a provision could not be included without "complicated legal rigmarole." Our attorneys advise me that such is not the case at all. Mr. Schenker states, and here I quote:

Now if I may be a little slangy about it, we don't think it is worth the fuss to draw an elaborate provision which probably would be page after page to provide for the situation where a company may want at some subsequent date to issue a little preferred stock.

Our contention is, and I should like to make it as forceful as possible, that it would be relatively easy to draw a provision permitting the issuance of one class of senior securities within certain prescribed limitations.