Mr. L. M. C. SMITH. Senator, I should like to ask permission to have put in the record a statement on sections 18, 19 (b), and 21 (c), relating to capital structure, which discusses the arguments of the various persons who spoke in regard to capital structure.

Senator HUGHES. Very well; it will be received.

(Memorandum entitled "Provisions of the proposed bill relating to capital structure, secs. 18, 19 (b), and 21 (c)" is as follows: Exhibits referred to are filed with the Committee, but are not herewith printed.)

PROVISIONS OF THE PROPOSED BILL RELATING TO CAPITAL STRUCTURE

(Secs. 18, 19b, and 21c)

THE SENIOR SECURITIES OF LEVERAGE INVESTMENT COMPANIES; ACTUAL EXPERIENCE COMPANIES

THE SENIOR SECURITIES OF LEVERAGE INVESTMENT COMPANIES; ACTUAL EXPERIENCE COMPARED WITH PROMISED RETURN AND SAFETY

Raymond D. McGrath, the executive vice president of General American Investors Co., Inc., urged that the senior securities of his company must be considered good investments because the bonds and preferred stock of that company are at present selling in the market near their call price. Mr. Quinn of Tri-Continental Corporation objected to the statement by the counsel for the investment trust study that some preferred stocks could be purchased at 50 cents on the dollar, and cited several preferred stocks which had a market value not very far from the liquidating value, to wit:

	Involuntary liquidating value	Market price
Tri-Continental Corporation Preferred	$100.00	$81.00
United States & Foreign Securities Corporation Preferred	100.00	93.00
Capital Administration Co., Ltd., Preferred	50.00	47.50

It will, of course, be observed that in citing these companies these witnesses have mentioned four investment companies whose preferred stocks stand among the highest on the market in the entire investment-company industry. The February 19, 1940, issue of Barron's the National Financial Weekly states (exhibit A):

"With one or two notable exceptions, current prices (of investment-trust preferred stocks) are 20 to 40 percent below the amounts which holders of these securities would receive if the assets of the companies were liquidated at present market prices."

The table of 16 selected investment-company preferred stocks presented in this publication shows at December 30, 1939, a market discount from asset value of 58 percent in one case, 50 percent in another, and 44 percent in a third instance. That list contains, amongst the 16, the 4 companies cited by Messrs. McGrath and Quinn and shows that the discounts on December 30, 1939, in those very securities were:

	Percent
Tri-Continental Corporation preferred	22
Capital Administration Co., Ltd., preferred	20
United States & Foreign Securities Corporation preferred	16

General American Investors Co., Inc., was the only company whose preferred stock was selling at a slight premium, to wit, 2 percent.

It would seem rather difficult to make out a case for the investment merit of the preferred stocks of investment companies for the period of the history of these companies. Even the holders of many of the most choice of the investment-company preferred stocks are at present, and have been for years, unable to

realize on the market the face amount of their security. Barron's publication, in introducing the statistics on the investment-company preferred stocks referred to above, states:

"If there is a 'forgotten security', the preferred shares of management investment trusts must be considered among leading contenders for the title."

In order to judge the fulfilment of the promises on which the preferred stocks of investment companies were sold, the history and status of the preferred stocks in general—and not the preferred stocks of 4 or 16 selected stocks—must be scrutinized. In the matter of arrearages, a survey of 58 investment companies with preferred stock outstanding (68 issues) shows that at the end of 1939, 35 companies were in arrears with respect to the payment of dividends on 40 issues, these arrearages aggregating $78,985,693.[1] Of 749 preferred-stock issues of noninvestment companies registered under the Securities Act of 1934, 234 were in arrears at the end of 1937, or 30 percent.

In addition to the failure in so large a proportion of cases to pay the stipulated dividend on the preferred stocks, investment companies have in a surprisingly large proportion of cases failed to preserve the principal or face amount of the investment of the preferred-stock holder. While out of Barron's selected list of 16 preferred stocks, 2 were "under water" on December 31, 1939, a recent check on 68 preferred issues shows that 33 of the issues were "under water" on December 31, 1939. That is to say, in the case of almost 50 percent of the preferred issues, the companies did not have enough assets to pay the involuntary liquidating value of these securities.

Mr. Quinn of Tri-Continental Corporation questioned the statistical procedure employed by the investment trust staff to show that investment companies could not be expected to earn as regular income the rate that these companies promised to pay on their senior securities. He did not, however, attempt to challenge the fact that, in the overwhelming majority of cases, the investment companies have in actual fact failed to earn a rate of regular income equal to the rate on their senior securities. There is annexed hereto a table (exhibit B) which shows that, out of 71 companies with senior securities at the end of 1938 (admittedly a year of poor earnings, but the latest for which full information was available, there were only 5 which, during that year, earned net, after operating expenses, 5 percent or more on their total assets; there were only 13 which earned 4 percent or more on their total assets. The average (median) rate of net ordinary income (after operating expenses and taxes other than Federal income tax) was 2.47 percent.[2] These rates of earnings may be compared with the dividend and interest rates promised on the senior securities of these companies, shown in the annexed table (exhibit B). Of the 111 senior issues, 99 carried a rate of at least 5 percent.

It is also very instructive that an analysis of a sample consisting of 17 leverage investment companies shows that during 1937, 1938, and 1939, 10 of these companies could not meet their senior interest and dividend requirements out of a combination of ordinary income and capital gains in any one of these 3 years (exhibit C). We are not speaking now of rate of earnings compared with rate of fixed charges but the actual earnings of the company on its entire capital. In short, with the use of their whole capital, 10 companies could not earn enough from both regular income (to wit, interest and dividends on their investments) and capital gains (i. e., profits on the purchase and sale of securities) to meet the actual charges on their senior securities during any one of these years.

We note that among these 17 companies is Tri-Continental Corporation, the company of which Mr. Quinn is executive vice president. The percentage

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[1] Default in the payment of dividends on preferred stocks has been a common phenomenon among investment companies for the past decade. Out of a total of 92 leverage investment companies, 75 passed a dividend on their preferred stock in the period 1927–35; out of 117 issues of preferred stock by these companies, 98 passed a dividend. Thirty-six of the issues failed to distribute dividends for a period as long as from 3 to 4 years; 26 from 2 to 3 years. Since these preferred stocks were outstanding on the average for only somewhat over 7 years, it appears that they failed to pay dividends during about one-half of their life. In the year 1935 the 92 management investment companies failed to pay current dividends amounting in the aggregate to $19,700,000. In the years 1932 to 1934, inclusive, these companies fell short more than $20,000,000 each year in the payment of current dividends on their preferred stock.

In addition, these defaults do not include the instances where payments were made from paid-in surplus or capital surplus created by a restatement of capital, tantamount to merely a return of capital.

[2] Over the period 1930–36, net ordinary income of management investment companies proper averaged only 3 percent of total assets at market value.

of net ordinary income to average assets in that company was as follows: 1936, 4.5 percent; 1937, 4.3 percent; 1938, 2.4 percent; 1939, 3.2 percent.

On the debentures the company had to pay 5 percent; on the preferred 6 percent. Its net ordinary income fell short of the senior charges in 1938 and 1939; was adequate in 1937. Net income, including realized capital gains and losses, fell short of the amount required for fixed charges in 1939; was adequate in 1937 and 1938.

Selected Industries, Inc., which is an investment company affiliate of Tri-Continental Corporation, and which undertook to pay a 5½ percent dividend on its prior preferred stock and a 5 percent dividend on its convertible preferred stock, earned the following rates of net ordinary income to average assets: 1937, 3.8 percent; 1938, 3 percent; 1939, 3.8 percent.

The entire net ordinary income was insufficient to pay the required dividends on the preferred stocks in any of these 3 years.

Capital Administration Co., Ltd., another investment company affiliate of Tri-Continental Corporation which has a preferred stock with a dividend rate of 6 percent, earned a net ordinary income bearing the following percentage relationship to average assets: 1937, 4 percent; 1938, 2.7 percent; 1939, 3.6 percent.

As the dividend requirements on its preferred stock totaled only $130,200, the net ordinary income was sufficient to pay that dividend.

General American Investors Co., Inc., whose preferred stock had the highest market standing, earned as the percentage of net ordinary income to average assets: 1937, 3.6 percent; 1938, 2.5 percent; 1939, 2.8 percent.

The net ordinary income was insufficient to cover the fixed charges in 1938, and sufficient in 1937 and 1939.

United States and Foreign Securities Corporation, which was mentioned by Mr. Quinn as one of the companies whose preferred stock had a particularly high market standing, earned: 1937, 4.5 percent; 1938, 3.5 percent; 1939, 3.9 percent.

Its net ordinary income was sufficient to cover the senior security requirements in 1937, but insufficient in 1938 and 1939. The net ordinary income, including capital gains, was insufficient to cover the fixed charges in 1938 and 1939.

The 17 companies combined failed to earn an aggregate ordinary income sufficient to meet their total senior requirements in any one of these years. Their aggregate net income including capital gains also fell far short of meeting their total senior requirements.[3]

The data show very clearly that the leverage investment companies almost invariably fail to earn a regular income at a rate sufficient to justify the charges on the senior securities. It would appear that the foregoing is a sounder explanation why the preferred shares of investment companies constitute the forgotten security than the theory that it is due to the fact that investment companies have been studied by the Securities and Exchange Commission, as suggested by one of the witnesses before the Committee. The public disfavor into which the preferred stocks of investment companies have fallen may be in part attributed to the heavy losses suffered by preferred stockholders in the years following 1929, and the realization by a greater part of the public of this basic economic unsoundness of the senior securities of leverage companies.

It might be added here that, if there is no economic justification in the rate of earning power for senior securities of investment companies, there is a logical basis for not permitting the issuance of additional senior securities rather than limiting the relative proportion of senior securities n the capitalization. There would appear to be no reason why an investment company should be permitted, in effect, to promise to the contributors of even one-third of its capitalization that it will pay them 6 percent or 5½ percent for the use of their money, when the investment company can reasonably be expected to earn on the average only 2 or 3 percent on that money.

THE COMMON STOCK OF LEVERAGE INVESTMENT COMPANIES

Several witnesses from the industry appear to have assumed that the sole reason for recommending the prevention of the issuance of additional senior securities in the investment company field is the desire to protect the senior

[3] For the 17 leverage companies combined, net ordinary income would have had to increase by 25 percent in 1937, 108 percent in 1938, and 79 percent in 1939, in order for these companies to meet their senior requirements.

security holder. As a matter of fact, it is the weakness of the common stock of the leverage investment company, the extreme dangers to which that stock is exposed, and the lack of investment merit in that security that requires a prohibition upon the possible expansion of the multiple-security investment company. The end sought by section 18 in preventing the further issuance of senior securities is at least as much the prevention of the marketing of additional leverage common stocks as the senior securities of leverage investment companies. It is true that existing leverage companies have the right to issue additional common stock, but issuance of additional common stock by existing leverage companes serves to reduce the dangers to both the existing common stock and senior securities of those companies; whereas the issuance of additional senior securities would increase the dangers of both types of securities.

If one is to scrutinize the investment merit of the securities of leverage companies, it is not adequate to examine the status merely of the preferred stock of such companies, as some of the witnesses before the subcommittee have done; but it is necessary to investigate the history and status of the common stock of leverage investment companies. Since such companies issue these different kinds of securities to the small investor—of whom so much has been said—in exchange for his savings, it would seem that these companies have a responsibility also to that part of the public which entrusts its funds to them in return for the common stock.

The Commission believes that it has been clearly shown that it is the leverage aspect of the senior-junior capital structure in investment companies—a condition which, of course, does not exist in the single stock company—which may be held accountable for a large part of the losses which have been suffered by the investor who purchased the common stock of the leverage company.

The common stock of a leverage investment company is a very volatile and hazardous security. When the securities market is rising, the common stock has the advantage of trading on the senior security capital and receiving the major part of the market appreciation. This naturally causes a great rise in asset value and generally in the market price of the common stock. If an investment company which has been capitalized at a 3 to 1 leverage ratio (i. e., when the senior securities represent $600,000 and the common stock represents $300,000 of the contributed capital) makes a profit within the first year of operations of 10 percent on its total assets (to wit, $90,000 over the fixed charges), this entire increase in assets inures to the common stock, which has thus earned 30 percent on its invested capital. On the other hand, a 10 percent loss on the whole fund, after fixed charges, is reflected in a 30 percent loss on the common stock capital investment—hence, volatility is always present with leverage.

Both the sharp rises and the sharp declines in assets will have a repercussion on the market price of the common stock. Because of the leverage influence, a substantial swing of the securities market is likely to deprive the common stock of a leverage investment company of both its asset and market value.

The volatility of the common stock of leverage investment companies accounts for a considerable part of the losses sustained by investors. The statistics on market prices are very eloquent on this point. The average dollar invested in July 1929 in the common stock of leverage investment companies had declined to about 2 cents in value in June 1932. At the end of 1937 it was worth 5 cents, and was worth approximately 5 cents at the end of 1939. On the other hand, the average dollar invested in the common stock of nonleverage investment companies fell only to 21 cents in June 1932, was worth 48 cents at the end of 1937, and about 47 cents at the end of 1939. While the investor who bought a share of common stock of a leverage investment company in July 1929, had, on the average, lost 95.1 percent on his investment, the purchaser of a share of nonleverage common stock had lost only 52.7 percent. (Exhibit D.) It may be relevant to point out that had investment companies been simple structure companies exclusively, a very substantial part of the losses sustained by investors in the common stock would have been avoided.

In this connection, we would like to note the difference in the percentage of shrinkage of the asset values of the common stock of leverage and nonleverage companies. Of course, the equity of the common stock of both leverage and nonleverage companies shrank between 1929 and 1935; but the shrinkage in the asset value of a dollar invested in the common stock of leverage companies was 79 cents, while that of the nonleverage companies was 28 cents—or over three times better for nonleverage.

The conclusion to be drawn from the operation of the principle of leverage and from these statistics is that the common stock of leverage investment companies is so fraught with danger to the investor and so hazardous a commodity that it is definitely inappropriate as an offering of a public investment institution, especially upon consideration of the sales emphasis of investment companies upon the savings and investment character of the securities of such companies.

It might be interesting to note some of the vicissitudes of the common stock of General American Investors Co., Inc., in connection with which Mr. McGrath observed that it "has a book value which is higher than the price at which it was originally offered to the public" although "it is selling at a substantial discount from its book value in line with all other stocks of closed-end investment trusts." On December 30, 1939, the common stock of that company had an asset value per share of $11.81, and was selling at a market price of $5⅝. In making the statement that the common stock has at present a book value greater than the price at which the common stock was originally offered to the public, Mr. McGrath referred to the price of $10 per share which the public paid for such common stock as it received in the original distribution. However, the investing public, which bought the common stock that the sponsors disposed of on the market at the prevailing high prices, paid a price much higher than $10 per share.

It must be noted that as rapid as may be the ascent, under favorable circumstances, of the market prices of equity stocks in a complex capital structure, at least as rapid will be the descent of these equity stocks, when the purchasing public reaches the end of its optimism. Before such time, however, the sponsors, in many instances have disposed of a significant portion of their holdings to the public at large profits.

The present General American Investors Co., Inc., is the result of the merger in 1929 of the initial General American Investors Co., Inc., with Second General American Investors Co., Inc. In the merger, Second General American Investors Co., Inc., assumed the debentures of the original General American Investors Co., Inc., and exchanged its common stock for that of General American Investors Co., Inc., on a share-for-share basis.

The initial company, General American Investors Co., Inc., was originally created in the State of Delaware on January 25, 1927, with $9,000,000 in senior securities as against $300,000 in common stock—a leverage ratio of 31 to 1.[4] The public put in $7,500,000 for which they received $7,500,000 of debentures and warrants entitling them to 75,000 shares of common stock which were later exercised. The sponsors put in $1,800,000 for which they received 15,000 shares of preferred stock at par and 125,000 shares of common stock. However, although part of the sponsors' contribution was in the form of the preferred stock, all of the sponsors' contribution was in a junior position to the public's contribution in the debentures. The ratio of the public's contribution to the sponsors' contribution was 4.16 to 1.

The effect of this leverage structure of the original company in a period of rising prices became apparent in the impetus given the equity stock marketwise. The market price of the common stock had ranged in 1928 from a low of $56⅛ in February to a high of $88⅜ in December. These values represented substantial premiums over the stock's asset value of $9.26 per share at the beginning of the year and $25.39 per share at the close of the year.

The sponsors, taking advantage of the high level in market price attained by the common stock in December 1928, disposed of 18,620 shares to the public for $1,365,221,[5] or at a profit of $1,320,533 over the original cost to the sponsors of these shares. Thus, by disposing of this portion of the 125,000 shares originally taken down, the sponsors realized a profit of $1,065,221 over the cost to them of the entire block. However, it must be noted, the sponsors retained by far the largest part of their holdings and subsequently, when the market

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[4] The initial company sold $7,500,000 of 5 percent debentures to the public. The debentures carried nondetachable warrants entitling the holders to receive, without cost, 75,000 shares of common stock. The sponsors purchased $1,500,000 par value of 6 percent cumulative nonvoting preferred stock (15,000 shares). There were issued to the 2 sponsors for an assigned consideration of $300,000, 125,000 shares of common stock. The sponsors paid $1,800,000 in all for the preferred stock and their common stock.

[5] Subsequent to subscribing originally to 125,000 shares and up to this disposition, the sponsors had purchased 5,100 shares at average market prices and had sold 3,680 at about average prices. Some shares of the balance therefore might have been included in the 18,220 shares sold at this time.

declined, faced losses far larger than the profits made—of course, the record does not indicate the extent, if any, to which the original investing public realized any profits.

The investing public which had bought these shares from the sponsors at an average price of approximately $73 per share was faced with severe losses both in asset and market value in the period of deflation following 1929. By the end of 1932 the common stock of the present General American Investors Co., Inc., had fallen to a low of 13 cents per share in asset value. On December 30, 1939, the asset value of a share of common stock of the present company was $11.81, and the market price was $5⅝.[6]

A like procedure was followed with the Second General American Investors Co., Inc. By disposing of 178,165 shares of this common stock for $3,004,818, the sponsors realized a profit of $1,223,168 above the cost of the shares sold. The purchasers paid an average of $16.87 per share. As stated, at the end of 1932, this stock had an asset value of but 13 cents per share, and on December 30, 1939, the asset value and market price of the common stock were $11.81 and $5⅝ respectively.

In connection with how the leverage investment companies have served the public holder of the comon stock, it is interesting to note that even the best performing companies which have managed to pay dividends on senior securities have either entirely failed to pay any dividends, or paid an occasional trivial dividend to the common stock, since the period of the market decline. The witness from General American Investors Co., Inc., announced in his opening remarks that his company had paid out $6,774,925 in dividends in a period of 13 years. However, only two dividends—one dividend of 75 cents per share and another of 25 cents per share—were paid on the common stock of that company since its formation. The first dividend was paid on December 19, 1936, to stock of record December 15, 1936, and the second dividend was paid on December 22, 1939; no dividends had been paid prior thereto, and none had been paid thereafter. As to the companies with which Mr. Quinn is associated—Tri-Continental Corporation and its subsidiaries, Capital Administration Co., Ltd., and Selected Industries, Inc.—the following are the earnings which the common-stock holders have reaped:

Tri-Continental Corporation.—Initial dividend of 25 cents per share paid October 31, 1936; December 24, 1936, and July 1, 1937, 25 cents each; none thereafter.

Capital Administration Co., Ltd.—This company, in addition to a bank loan and a cumulative preferred stock, has class A and class B common stock. The class A common stock is in reality a senior security because it has a priority claim of $20 per share in involuntary liquidation. Since the class A stock has only a per share asset value of $12.29, it is really "under water" at the present time.[7] The dividends paid on the class A and the class B stock have been as follows:

Class A: Initial dividend of 50 cents per share paid October 31, 1936; December 24, 1936, and June 14, 1937, 50 cents each; none thereafter.

Class B: Initial dividend of 12.8 cents paid October 1, 1936; December 24, 1936, and June 14, 1937—12.8 cents each; none thereafter.

Selected Industries, Inc.—No dividends have ever been paid on the common stock. At the end of 1939 there were accumulated arrears of $10 per share on the cumulative convertible stock. The prior preferred was $10 a share "under water." The convertible preferred had no asset value whatever.

U. S. & Foreign Securities Corporation.—The other investment company mentioned by Mr. Quinn as showing a particularly meritorious performance—no dividends on the common stock have ever been paid. At the end of 1939 there were arrears of $57 on the second preferred stock.

Attributes of investment companies which make the regulation of their capital structure especially significant.—Cyril J. C. Quinn, executive vice president of Tri-Continental Corporation, inquired why the capital structure of investment companies should be subjected to Government regulation whereas the capital structures of other corporations are not restricted.

"Now, where, in any of these sections, is there any characterization of investment-company senior securities which can be differentiated in the slightest from the senior securities of any American form of business? If they are inequitable provisions and if they are bad, they are bad for every industrial company and not only for the investment companies. If control or management is irrespon-

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[6] These sales were made prior to the distribution of a share-for-share stock dividend. Hence, the market price of two shares must be used in comparison with the sales price.

[7] It should be noted that, although the class B common stock has no asset value (and the class A stock is "under water"), the class B stock still has the right to elect two-thirds of the board of directors.

sibly held, it can be just as bad for an industrial company as it can be for an investment company.

"Nobody disputes the fact that borrowing and issuance of senior securities may tend to increase the speculative character of junior securities, but how in the world can this be said to apply to investment companies any more than it can be said to apply to any business?

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"In the declaration of policy and in the discussion of section 18 here, there has been no single important reason adduced regarding the senior securities in an investment company which cannot with equal force and equal validity be applied to all companies in all businesses.

"The important question is thus squarely posed:

"Is Congress prepared to say that there is something so intrinsically wrong with senior securities generally that their future issuance can be prohibited?

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"The next argument that they advance in favor of abolishing senior securities in the future is that there are arrearages in senior securities outstanding in the investment companies at the present time, and that some of them are under water; that is, the assets of the company are not included in the outstanding obligations.

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"What is the inference of the argument? Are railroad bonds to be legislated out of future existence because a substantial portion of the outstanding bonds of railroads are in default? Are preferred stocks of industrial companies to be washed out in the future because during the depression a great many of them passed their dividends and have since failed to make them up?"

INVESTMENT COMPANY POOLS AND THEIR RESEMBLANCE TO "TRUST FUNDS"

We are not dealing with anything but investment companies. We reiterate that investment companies are trusts of money from the public which the company invests for what in a sense are its clients. It is because Congress looked at this matter of individuals putting their savings into the hands of others for investment as something different from an investor deciding that a particular steel manufacturing concern was a good investment (and hence either lent his money to the company on a bond or preferred stock,[8] or sought to participate in its surplus profits) that Congress directed an inquiry into the manner in which these companies recruited their funds and the manner in which the contributors of the funds had been served.

The witnesses from the industry have brought into issue a really fundamental question, to wit: Is the Government justified in exercising a greater protective jurisdiction over funds which are solicited and sought to be handled by these investment companies than over investments which people deliberately make in specific industrial enterprises? Congress apparently thought there was a difference because it directed the Securities and Exchange Commission to study the capital structure and financing of investment companies and not senior securities in general.[9]

Our primary answer to this cardinal question is that the people who put their money into investment companies are not really investing in the company but are entrusting their funds for management—they are in a broad sense cestuis que trust of the management and not individuals who are lending their money to or are adventurous in a specifically defined and particularized industrial enterprise.

The industry has peculiar responsibilities which it owes to the public in the matter of the terms and conditions upon which an investment company shall solicit money from the public and in the matter of fulfilling the obligations it has assumed.

It is suggested that the manager has no more responsibility than if he were seeking to interest an investor in an automobile factory or a bus line. But it is traditional that the law shows greater concern for people who entrust their money to other people to handle it for them than for people who invest their money in a specific enterprise. Greater supervisions and more restraints are imposed in the former category.

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[8] We cannot get away from realism—a preferred stockholder is essentially (although not legally) a lender of money without a due date because he rarely is allowed more than the fixed dividend.

[9] Eminent authorities on finance have argued that preferred stocks in general are poor investment securities and have also argued that the burden of fixed debt has a demoralizing influence on industry, but it is not necessary for us to take any side on this general controversy.

Banks are segregated from other industries, in the matter of restraint, because they accept money from the public without that money being dedicated to a specific industrial enterprise, and the recipient would hence be free to utilize the fund in any manner it wishes. Insurance companies are under restraint because money is entrusted to them to be continually handled by them as money and not to be devoted to some industrial enterprise. In short, the continuous handling of money of others is a ground of differentiation between institutions engaged primarily in this practice and the ordinary industrial enterprises, and it is in the former class that the Commission believes investment companies belong.

Thus there is a reasonable basis for maintaining that organizations which hold themselves out as the managers of funds which will be entrusted to them shall be restricted in the terms that they offer to their investors; to justify the above restriction it is unnecessary to show that organizations which are operating a particular industrial enterprise should similarly be restricted in the terms which they may make with those who wish to participate in that enterprise.

Investment company assets remain liquid pools.—Thus it appears that the law and statute tend to exact a greater fiduciary obligation from individuals or organizations which are supposed to preserve the liquid form of the money which is entrusted to them than from individuals or institutions which immediately transform the capital contribution into an agreed-upon productive or operating enterprise. The readily liquidable character of the assets of investment companies is a feature which vitally distinguishes these companies from the railroad companies and industrial enterprises with which it is sought to compare them. This characteristic of liquidity of assets makes the supervision of the relationships of the sponsor to the investor particularly necessary in the case of investment companies. In the first place, the investible funds, the trust res, so to speak, is subject to ready alienation, negotiation, or spoliation, whereas in the ordinary enterprise the greater part of the assets consists of property in a stable form such as refineries, smelters, glass furnaces, steamships, real estate, which are protected by documents of title, difficult of removal or exchange, and easy of identification. In the second place, because the sponsor or manager always has a large liquid pool of money at his disposal and he is not hemmed in by the limitation of a particular industrial enterprise, there is practically no restriction upon the uses or purposes to which he can put the fund. The fact of the liquidity of the assets of the investment companies and the further fact that the activities of the investment companies are unfettered, make the conflict of interest between the junior and senior securities of investment companies a far different matter than the conflict between such securities in other corporations.

Conflicts of interest continuous and acute in investment companies—only occasional in industrial companies.—Mr. Quinn's argument continues as follows:

"They next say that they want to eliminate senior securities in the future because there is an inherent conflict of interest between the junior security holders and the senior security holders. Now, of course, the interest of the senior security holders are not identical with those of the junior security holders. That is why they spell out these respective rights and privileges in a contract. But in what respect, gentlemen, is this different from the senior securities generally in any business?

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"Now they say that an investment company ought to be a mutual enterprise. This word "mutual" appears in their report, but I must confess that I don't understand exactly what they mean. The report reiterates the belief that there is a conflict of interest between different types of securities, imposing conflicting duties on management because the risks, losses, and gains are not equally distributed. In what respect does this differ from the senior security in any enterprise? To be logical, you'd have to extend this principle to every form of American business."

It is true that the potentialities of a conflict of interest may exist in the case of *any* corporation between the senior securities which can generally look forward to only a fixed and limited return and hence tend to favor a conservative policy and the equity securities which are entitled to all of the surplus profits and hence tend to favor a more speculative policy. But, this conflict rarely comes to bear upon the actual activities of industrial companies because the activities of such companies are definite, circumscribed, well established, and generally acceptable to all types of security holders. Compared to the possible variation of activities of investment companies the distinction be-

tween running a specific industrial enterprise in a conservative or a speculative fashion is relatively minor. While any corporation may from time to time oscillate—within a narrow orbit—between a somewhat more or less conservative policy in the conduct of its established line of activity, it cannot, like an investment company at the present time, within a few days entirely change the character of its activities, for example, from the use of its assets in diversified investment to speculative trading or to the financing of a single hazardous special interest. In short, while this conflict is possibly latent in the case of other companies the conflict in the case of investment companies is continuous and acute.

The same thing is true in connection with the inequities which, it has been shown, managements of multiple-security investment companies have perpetrated upon certain classes of security holders. It is quite true that "inside" interests of any multiple security company might be tempted to engage in practices favoring their particular type of shareholdings at the expense of other classes of shareholders or in disregard of the interest of the latter. Nevertheless, while the opportunities for such conduct occasionally arise in the case of operating, commercial and industrial enterprises they are ever-present and more easily available in the case of investment companies.

The holder of the control stock of any corporation may sell that stock at a premium, but that transfer is not as likely, as in the case of an investment company, to constitute the selling of the rest of the security holders "down the river," as the newcomer will not be getting control of a liquid fund which can be employed in inumerable ways, but of an enterprise of a well defined character. Cash dividends can be paid out of contributed capital and repurchases consummated in the case of any corporation, but the investment company is generally much more susceptible than other companies, as all of the assets of an investment company are in a form to be utilized for such purposes, whereas other companies, especially in periods of unsuccessful operation, usually have very little cash that might be employed in this fashion. There is little to motivate the controlling interest of an industrial company to take over a competitor or a company engaged in a closely related activity other than the prospect of prosecuting the same business on a larger scale or in a more efficient manner. The fact that investment companies constitute large pools of cash which may readily be put to any use serves as a motivation for sponsors of one investment company to acquire other investment companies so that they might deal with the assets of the acquired companies (and the rights of other security holders) as freely as with the assets of their own company.

It seems quite obvious that an opportunity to effect a shifting of asset values between classes of security holders or a prejudicial readjustment of rights and safeguards of the various classes of securities by the acquisition of other companies, or by mergers and consolidations is greater in the case of investment companies and investment-holding companies than in the case of ordinary industrial or commercial corporation. For the latter types of companies to consummate a merger or consolidation, problems of cash resources, disposal of equipment and physical properties, and coalescence of function must be solved. Investment companies, constituting, as they generally do, large pools of liquid assets and being practically unrestricted in the nature of their operations can much more readily engage in the acquisition of other investment companies or the consummation of mergers and consolidations with other investment companies.

The above is suggested in connection with the argument advanced by the apologists for the multiple-security capital structure in investment companies to the effect that control by a management which itself holds a greater proportion of common stock than senior securities is a common phenomenon in corporate life, not in any way limited to investment companies. The answer to this contention is, that whereas the senior security holders of other corporations may occasionally be prejudiced by specific acts of such a management, in the case of an investment company the entire policy of the company may be predicated upon and the entire welfare of the senior security holders be dependent upon the character of the capital structure and the pattern of distribution of the various types of securities among the sponsors and the outside public.

The discretion granted the Commission under the proposed act to require an equitable redistribution of voting privileges when existing distribution is inequitable.—The investment trust study disclosed that a considerable part of the investment company industry was organized in such a manner that a large