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SECURITIES AND EXCHANGE COMMISSION
Washington

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Statement of Commissioner Robert E. Healy before
subcommittee of Committee on Banking and Currency
on Wagner-Lea Act, S. 3580, to regulate invest-
ment trusts and investment companies.

Mr. Chairman and Senators:

My name is Robert E. Healy. I am a member of the Securities and Exchange Commission. I have had general supervision of the Commission's study of investment trusts and investment companies. I am here in behalf of the Bill as a representative of the Commission, which endorses the Bill and recommends to the Congress that it be adopted at the present session.

In 1935, when the Congress passed the Public Utility Holding Company Act, it included in it Section 30, which not only authorized, but directed, the Securities and Exchange Commission to make a study of investment trusts and investment companies, and to report its findings and recommendations to the Congress. The members of the staff and I will attempt to outline in some detail the results of our four years' survey of the industry, made pursuant to this mandate.

LET ME TRY MY HAND AT A GENERAL DESCRIPTION OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES. ESSENTIALLY THESE ORGANIZATIONS ARE LARGE LIQUID POOLS OF THE PUBLIC'S SAVINGS ENTRUSTED TO MANagements TO BE INVESTED. The sales and promotional literature of investment trusts and investment companies has created the impression that they are not unlike savings banks and insurance companies, except that they are not limited to so-called legal investments. The sales emphasis by promoters of investment companies has been upon the necessity for providing security for old age and for emergencies, and upon the claim that by expert management and diversification of risk, this security can be furnished by these organizations.

FOR EXAMPLE, CHARLES A. KETTERING, VICE-PRESIDENT AND RESEARCH DIRECTOR OF GENERAL MOTORS CORPORATION, TESTIFIED at the public examination that in 1930 he purchased 40,000 shares of an investment company for \$260,000 in the belief that it gave him a participation in a wide range of securities and was "akin or about the same participation you would get in, say, one of these single payment life insurance companies." He said that he did not know that investment companies were not subject to supervision as were life insurance companies or banks. Ultimately Mr. Kettering realized only \$20,000 on his investment--that is, he lost approximately a quarter of a million dollars.

THE INTEREST OF THE PUBLIC IN INVESTMENT TRUSTS AND INVESTMENT COMPANIES HAS BEEN AND STILL IS VERY LARGE.

IN THE LAST FIFTEEN YEARS APPROXIMATELY 1300 SUCH COMPANIES HAVE BEEN CREATED. Speaking generally these organizations have made comparatively little original contribution of capital to industry. The American public has contributed over \$7,000,000,000 to these organizations. The value of their assets

at present is approximately \$4,000,000,000. At present only some 650 or approximately one-half of investment companies formed in this country, are still in existence. The other companies have disappeared through bankruptcy, receivership, dissolution, mergers and consolidations. With respect to 22 of the bankrupt companies upon which the Commission has reasonably accurate figures, the security holders sustained a capital loss to December 31, 1935 of approximately \$510,000,000 out of a total net capital contribution of almost \$560,000,000, or a loss of about 90%. Altogether investors have sustained a capital shrinkage of approximately \$3,000,000,000 in all types of investment trusts and investment companies.

MANY INDIVIDUAL INVESTMENT COMPANIES HAVE TOTAL ASSETS EQUAL TO THOSE OF THE LARGER SAVINGS BANKS. THEIR SECURITIES ARE OWNED BY APPROXIMATELY 2,000,000 INVESTORS throughout this country, with the majority of the individual investments in such securities having a value of under \$500. The number of security holders of investment trusts and companies probably exceeds that of all other industries except utility holding company systems. It is estimated that one out of every ten holders of securities of all types in this country is a holder of investment trust and investment company shares or certificates.

IN ADDITION, INVESTMENT COMPANIES AT PRESENT CONTROL OR ARE IN A POSITION TO CONTROL OF INFLUENCE VARIOUS INDUSTRIAL, BANKING, UTILITY AND OTHER ENTERPRISES HAVING TOTAL ASSETS WHICH, AS OF THE END OF 1935, AMOUNTED TO SOME 30 BILLIONS OF DOLLARS. Furthermore, these investment trusts and investment companies, because of their very substantial trading in securities on stock exchanges, are a most substantial factor in our securities markets.

BECAUSE OF THE LARGE PUBLIC INTEREST IN THESE ORGANIZATIONS, AND BECAUSE THESE INVESTMENT TRUSTS AND INVESTMENT COMPANIES REPRESENT UNSUPERVISED POOLS OF SAVINGS, THESE INSTITUTIONS HAVE BEEN A MATTER OF CONCERN TO REPRESENTATIVES OF THE INVESTMENT COMPANY INDUSTRY, STOCK EXCHANGES, FINANCIAL WRITERS AND GOVERNMENTAL BODIES FROM THE EARLY PERIOD OF THEIR EXISTENCE IN THIS COUNTRY. The potential dangers of these organizations has been indicated and with the passing years criticism has increased.

IN THE YEAR 1928, THE ATTORNEY GENERAL OF THE STATE OF NEW YORK CONDUCTED AN INVESTIGATION OF INVESTMENT TRUSTS. He recommended that investment trusts be required to incorporate under the banking laws and be subject to the supervision of the State Banking Superintendent.

IN MARCH, 1929, PAUL CABOT, WHO HAS BEEN ASSOCIATED WITH THE STATE STREET INVESTMENT CORPORATION SINCE ITS INCEPTION, IN AN ARTICLE IN "THE ATLANTIC MONTHLY", PREDICTED THAT, UNLESS PROMOTERS IN THE UNITED STATES AVOIDED THE "ERRORS OF FALSE PRINCIPLES" COMMITTED IN THE EARLY HISTORY OF INVESTMENT TRUSTS IN ENGLAND, * * * "WE (IN THE UNITED STATES) SHALL INEVITABLY GO THROUGH A SIMILAR PERIOD OF DISASTER AND DISGRACE." In the opinion of Mr. Cabot, the two major abuses of the industry were: (1) the companies were being operated primarily to serve the self-interest of the sponsors rather than the best interests of shareholders; (2) investment companies were being used as receptacles for otherwise unmarketable securities. The author stated that he had testified before a committee of the New York Stock Exchange that the common and general abuses of the investment trust promoters and managers can be traced to "dishonesty," "inattention," "inability," and "greed" and cited various illustrations in support of his contention.

PRIOR TO JUNE, 1929, THE NEW YORK STOCK EXCHANGE DID NOT LIST THE SECURITIES OF INVESTMENT TRUSTS OR INVESTMENT COMPANIES. The reasons which prompted the Exchange generally to deny such listing were not specifically expressed in any rules or regulations or public statements. However, one of the members of the New York Stock Exchange who, in the early 1920's, had discussed with the Exchange officials the prospect of forming and listing an investment company, stated that the Exchange felt that these organizations were "blind pools."

THE NEW YORK STOCK EXCHANGE APPARENTLY WAS SUBSTANTIALLY CONCERNED WITH THE PROBLEMS OF INVESTMENT TRUSTS EVEN AFTER THEIR SECURITIES WERE ADMITTED TO LISTING. In 1931, the Exchange adopted some tentative requirements with respect to listing the securities of these companies, stating:

"It has been urged that the public interest in Investment Trusts is entitled to adequate representation on directorates, and that such independent representation should be had through qualified individuals not directly affiliated either with the management of the trust itself or with its banking sponsors, if any.

"It is felt that, in default of such representation, the possibility of questionable transactions between investment trusts and their banking sponsors exists, and that this danger may lead to the feeling that Investment Trusts are not always managed with an eye single to the interests of their own stockholders.

"Against any such suspicion, Investment Trusts should be protected, and this protection will in the long run prove a benefit not only to the public but to the Trusts themselves, and the banking houses with which they are at times identified.

"It appears to the Committee as if such protection could be most readily obtained by independent directors under whose scrutiny and friendly criticism contemplated transactions would pass for review.

"This view will weigh with the Committee in considering listing applications."

THIS COMMITTEE (Banking and Currency Committee of Senate), IN JUNE, 1934, IN ITS REPORT ON STOCK EXCHANGE PRACTICES, DISCUSSED INVESTMENT TRUSTS AND INVESTMENT COMPANIES AND SAID:

"The facility of perverted uses of these companies requires that these trusts be circumscribed with protective safeguards. The record indicates that it may be necessary to simplify the capital structures of investment trusts to prevent the organizers from usurping control and a disproportionate part of the equity and yield of these trusts; to limit and prescribe the concentration of securities in a particular industry; to prevent the diversion of these trusts from their normal channels of diversified investment to the abnormal avenues of control of industry; to prohibit pyramiding of investment trusts; to completely divorce investment trusts from investment banking; to eliminate the conflict of interest between investment managers and the public; to compel full and complete disclosure of the organization, capital structure, and management of the conduct of investment trusts."

AND FINALLY, IN 1935, AS THE CULMINATION OF THIS INTEREST AND THESE MISGIVINGS CONCERNING THE OPERATION OF INVESTMENT COMPANIES, THE CONGRESS DIRECTED THE S.E.C., IN SECTION 30 OF THE PUBLIC UTILITY HOLDING COMPANY ACT, TO MAKE

THE STUDY ON WHICH I AM NOW REPORTING, The inclusion of this provision in a statute dealing with public utility holding companies suggests that Congress was moved, not alone by the considerations referred to in the 1934 report of this Committee, but also by the suspicion that there might exist upstairs, above the utility holding companies, various investment trusts which had not been examined by the Federal Trade Commission or the committees of Congress. As will appear later, these suspicions were well-founded. There are a number of these investment trusts which were rather intimately connected with holding companies in the public utility field.

THE STUDY OF THESE COMPANIES HAS BEEN MADE BY THE COMMISSION AS DIRECTED BY CONGRESS, AND I WISH TO POINT OUT IN A GENERAL WAY WHAT THE STUDY HAS DISCLOSED. BEFORE I DO THIS, HOWEVER, I WISH TO MAKE IT CLEAR THAT I AM NOT HERE TO SAY TO THE COMMITTEE THAT ALL INVESTMENT TRUSTS AND ALL INVESTMENT COMPANIES ARE BAD, OR THAT ALL MEN IN THE BUSINESS ARE UNTRUSTWORTHY. Nor do I want to imply that all the evils and malpractices which we uncovered, and which we will discuss in detail, existed in all types of companies to the same degree or extent, or that some improvement has not been recently attempted by various companies. BUT I MUST SAY, BECAUSE IT IS THE TRUTH, THAT, CONSIDERED AS A WHOLE, THE RECORD OF THE INDUSTRY IS SHOCKING. The most pessimistic prophets of the dire consequences to the investor of unregulated investment trusts have been justified.

I SHALL NOT NOW ATTEMPT TO REHEARSE THE NUMEROUS ABUSES WHICH THE STUDY HAS DISCLOSED. They will be explained to you in some detail later in the hearings. However, on the basis of the record, I am constrained to state that too often investment trusts and investment companies were organized and operated as adjuncts to the business of the sponsors and insiders to advance their personal interest at the expense of and to the detriment of their stockholders. Too often, sponsors and managers and insiders disregarded their basic fiduciary obligation to their investors.

SUBORDINATION OF THE INTERESTS OF SECURITY HOLDERS TO THOSE OF PROMOTERS AND MANAGEMENT TAKES MANY FORMS. I am not speaking merely of the instances of outright embezzlement, I am referring to the unloading of worthless securities and other investments of doubtful value upon the companies; to loans which investment companies have been caused to make to insiders; to the bail-outs of insiders from dubious and illiquid investments, from onerous commitments and from trading accounts. Investment companies have been compelled to finance banking clients of the insiders, and companies in which they were personally interested. Some investment companies are organized to be operated essentially as discretionary brokerage accounts, with the insiders obtaining the brokerage commission. In many instances the abuses are more subtle but just as injurious to the investor. The public's funds are used to further the banking business of the insiders, to obtain control of various industrial enterprises, banks and insurance companies, so that the emoluments of this control will flow to these controlling persons, and otherwise to serve the personal interests of the sponsors and management.

ANOTHER FLAGRANT ABUSE IS THE ORGANIZATION OF INVESTMENT TRUSTS AND COMPANIES AS MANUFACTURERS OF SECURITIES, SO THAT PROMOTERS IN THE DISTRIBUTION BUSINESS CAN SELL THESE SECURITIES REGARDLESS OF THE ECONOMIC SOUNDNESS OF THE TRUSTS. SECURITIES HAVE BEEN PEDDLED FROM DOOR TO DOOR LIKE SO MUCH MERCHANDISE.

INSIDERS HAVE ALSO ENGAGED IN PRACTICES WHICH PERMITTED THEM TO OBTAIN LARGE PROFITS WITHOUT ANY RISK, BY TRADING IN THE SECURITIES ISSUED BY THE TRUST, TO THE PECUNIARY DETRIMENT OF THEIR INVESTORS. To increase their distribution profits and management fees, these insiders engaged in distribution practices which resulted in substantial dilution of the investors' interest.

TO PERMIT THESE PROMOTERS AND INSIDERS TO ACCOMPLISH THESE PERSONAL GAINS AND TO INSURE THEIR CONTROL OF THE PUBLIC FUNDS WITHOUT THE NECESSITY OF SUBSTANTIAL INVESTMENT OF THEIR OWN FUNDS, The charters of many of these companies have been drawn to allow the insiders to deal as principal with these trusts and companies and contain the broadest exculpatory clauses. Complicated capital structures have been devised. Tricky management stocks with disproportionate voting power are issued to insiders. Voting trusts are created. Insiders give themselves long-term management contracts. Boards of directors often consist solely or predominantly of representatives of banking, brokerage or distributor sponsors.

SO TOO, AFTER INVESTORS HAVE INVESTED SUBSTANTIAL SUMS IN COMPANIES ON THEIR FAITH IN THE REPUTATION AND STANDING OF THE EXISTING MANagements, THE INSIDERS HAVE FREQUENTLY TRANSFERRED CONTROL OF THE REMAINDER OF THE PUBLIC'S FUNDS TO OTHER PERSONS, WITHOUT THE PRIOR KNOWLEDGE OR CONSENT OF THESE SECURITY HOLDERS. TRAFFICKING IN CONTROL of investment trusts reached surprising proportions. The investor in many instances has been kept in ignorance of these occurrences because of the inadequate or even deceptive character of the companies' reports to their stockholders.

THE SERIOUSNESS OF THESE ABUSES IS INTENSIFIED BY THE FACT THAT HOLDERS OF INVESTMENT COMPANY SECURITIES ARE PECULIARLY INVESTORS IN THE LOW-INCOME BRACKETS. As I have indicated, during the relatively short period of their existence in this country investment trusts and companies have lost vast sums of money. The persons who paid for these losses constitute a class of investors who could least of all afford them.

THESE ARE NOT THE EVILS AND ABUSES OF THE PAST. The fact is that during the very course of the Commission's study some of the worst wrongs were perpetrated. The Commission had one particularly interesting experience. At one of our public examinations two witnesses were describing the manner in which they had depleted the assets of some investment trusts which they had formerly dominated. We later learned that these same individuals almost literally took time off from the public examination in order to complete their arrangements to loot some other investment trusts which had come under their control.

I AM CONVINCED, AS IS THE ENTIRE COMMISSION, THAT UNLESS THESE COMPANIES ARE SUPERVISED THEY WILL REPRESENT A SOURCE OF INJURY TO THE INVESTOR EXCEEDING ANY SOCIAL OR ECONOMIC FUNCTION THEY MAY SERVE. I realize that this is a grave assertion for any man to make about any industry, and I make it in all seriousness.

IT SHOULD HARDLY BE NECESSARY TO POINT OUT THAT EXISTING LEGISLATION IS NOT ADEQUATE TO MEET THE PROBLEMS PRESENTED BY THE INVESTMENT COMPANY. The mere recital of the abuses which have occurred since 1933 and 1934, tends to prove that the Securities Act of 1933 and the Securities Exchange Act of 1934, valuable as they are in most fields, are inadequate here. Because of the peculiar character of investment companies and their resemblance to savings banks, mere disclosure is inadequate as a remedy. Indeed, in many instances even publicity has not been achieved, since numerous companies have not found it necessary to register their securities with the Commission under either Act. The disclosure principle embodied in the Securities Act and Securities Exchange Act is a sound principle, but it has its limitations, and there is a point at which it breaks down. Let me quote from a leading editorial which appeared in the New York Times on November 12, 1936:

"Many investment trust officers would stop here, (publicity) holding that 'bright sunlight' is all that is needed, and that once this is brought to bear on trust affairs the investor himself must make his choice. But the experience of the last decade indicates that more than this is needed.

* * * * *

"Among the principal abuses of investment trusts have been their use as dumping grounds for unmarketable underwritings participated in by the banking house controlling the trusts; the too rapid turning over of their portfolios (often with the object of obtaining commissions for the banking house); a complicated financial structure; the acquisition of highly speculative instead of sound dividend-paying stocks; and the excessive concentration of investments in one or a few companies. Most of these abuses would not be difficult to correct. There are also other practices the wisdom of which, on grounds of public policy, is at least open to debate. These include, for example, the purchase of so large an amount of the stock of particular companies that the trust has a dominating voice in the management of those companies. Investment trusts, in any case, are as properly subject to regulation as savings banks and insurance companies. Such regulation has been long overdue."

THE CONCLUSIONS AND RECOMMENDATIONS OF THE COMMISSION ARE NOT BASED ON ANY CURSORY, HAPHAZARD SAMPLING OF THE INDUSTRY. Rather the study, at least in my opinion, is a comprehensive and objective survey of all the types of investment trusts and investment companies which exist or have existed in this country.

FROM ITS INCEPTION I WAS GIVEN GENERAL SUPERVISION OF THE STUDY. Paul P. Gourrich was made Director of the Study. (He resigned because of ill health in March 1939.) William H. Spratt, Jr. was made Chief of the Study and David Schenker was made Counsel. We recruited a staff of accountants and men with some experience and training in the investment trust field. Unhappily, Mr. Spratt had to submit to a major surgical operation. He failed to rally from it and died, largely, I believe, as the result of overwork and sticking too long to his post of duty.

WE DID NOT COMPLETE THE STUDY AND REPORT WITHIN THE TIME MENTIONED IN THE STATUTE. In that connection we must accept a reasonable amount of criticism.

The fact is, however, by way of explanation and not of excuse, that THE SIZE AND THE PROBLEMS OF THE INDUSTRY PROVED TO BE MUCH LARGER OR MORE COMPLICATED THAN EITHER WE OR CONGRESS EVIDENTLY ANTICIPATED. Moreover, during the course of the study many changes took place in the industry itself. In addition, when we were nearing the completion of our study, in fact after we had completed our public examinations, several investment companies were literally looted, and we had to reopen our investigation and conduct further hearings.

OUR METHOD OF CONDUCTING THE STUDY WAS ABOUT AS FOLLOWS: We prepared tentative questionnaires for each of the various types of companies and, as the Senators will see, there are a good many different types. We asked the various branches of the industry to organize committees to consult with us. They did so. We submitted the tentative questionnaires to them and considered all of their suggestions and then put the questionnaires in final form. The industry's committees did not give the questionnaires any formal approval, but they made very little objection to them.

Most of the information and data was accumulated from answers to these questionnaires. By the end of 1937, the Commission had received replies from about 700 trusts and companies of all types and from about 400 investment advisers. In addition, field studies were made of about 80 companies, which had been acquired and absorbed by two large investment companies during the period 1927 to 1935.

In addition to that, we sent accountants and examiners into the field to study the books and records of about 100 companies. Furthermore, we examined various state and court records to learn what we could about various lawsuits involving trusts and the history of various trusts which had become defunct. All in all, we collected our material from a great variety of sources.

After the examinations in the field and study of the questionnaires the staff prepared a detailed preliminary report on each company. The report was submitted to the company and its representatives were invited to come and talk with the staff about the report; and nearly all of them did so. The result was to promote better understanding of their problems on our side and also to afford them an opportunity to explain away, in some instances at least, facts which, superficially and unexplained, seemed a good deal more sensational than they turned out to be. (however, as the Senators will hear, there was no ultimate scarcity of examples of shocking abuses.) These conferences also had the virtue of preparing the companies for public hearing by letting them know what topics they were expected to testify about and what papers and records they were expected to bring.

In general, the next stage was the public examinations, which were held on 250 companies--practically every company which had \$10,000,000 or more of assets. In these public hearings the companies examined were entitled to be represented by counsel, to cross-examine witnesses produced by the Commission, and to present evidence through witnesses of their own choosing.

THE RECORD OF THESE PUBLIC EXAMINATIONS CONSISTS OF 93,000 PAGES OF TRANSCRIPT AND 4,800 EXHIBITS. The record was not ordered printed by Congress and therefore is only available in typewritten form. I think this is regrettable.

FROM TIME TO TIME, WE HAVE SENT REPORTS TO CONGRESS EMBODYING THE RESULTS OF THE STUDY. We referred to our main report as the "over-all" report which consists of four parts.

Part I of this over-all report, which we sent to Congress on the 10th day of June, 1938, was entitled "The Nature, Classification and Origin of Investment Companies."

Part II was entitled "Statistical Analysis of Investment Trusts and Investment Companies." This part, consisting of eight chapters, analyzes the companies on a detailed statistical basis as to performance, earnings, trading in portfolio securities, investors' experience, etc. Before submitting our chapter on performance to the Congress, we decided we would like a check on our statistical methods by an independent expert. Dr. Edwin B. Wilson, of Harvard University, an outstanding statistician of national reputation, was selected for this purpose. He examined the report and wrote us that "it was a thoroughly sound and substantial job".

Part III was entitled "Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies." It consists of seven chapters. It discusses, as the title indicates, the evils and malpractices of all the investment trusts and companies which we studied. All these chapters, except a part of the accounting chapter and a chapter containing a further elaboration upon the abuses in the management of assets have already been transmitted to the Congress.

Part IV, entitled "Economic Significance in Control of Industry," is an elaboration of those phases contained in the statistical portions. This part is in the process of being completed and will be transmitted to the Congress in the near future.

The Commission, in addition has prepared and sent to Congress six supplemental reports dealing with (a) fixed trusts; (b) installment investment plans; (c) British investment trusts; (d) investment advisory services; (e) common and commingled trust funds operated by banks and trust companies; (f) companies issuing face amount installment certificates. The latter is in page proof at the government printing office and will be available in about two weeks.

In this connection, I should like to state that in our recent report dealing with the accounting practices of the United Founders Companies, an expression of ours concerning accountants has been interpreted to mean that we think the mere fact that an auditor is paid by the corporation he audits destroys his independence. This is a misinterpretation. We take no such view. We did wish, however, to call attention to the possible effect upon the auditor's complete impartiality of the fact that he is usually both selected and paid by the management. We wished to emphasize the fact that he is selected and paid by the very management whose financial acts he undertakes to audit and appraise. We wished to emphasize the primary obligation nowadays of the auditor to act for the security holders, and to lay a foundation for the provision contained in this Bill requiring independent auditors to be selected by the stockholders. The value of this provision, I believe, is principally psychological. I hope that it will have the effect of keeping constantly before the auditor the realization that he acts principally for the stockholders and that in these modern days of widespread stock ownership he is now acting merely for the information of the directors or the discovery of peculations of employees.

THE REPORTS OF THE COMMISSION ALREADY TRANSMITTED TO THE CONGRESS COVER EVERY PHASE OF THE INDUSTRY'S ACTIVITIES. Before the Commission finally crystallized its recommendations, THE STAFF OF THE INVESTMENT TRUST STUDY HELD NUMEROUS CONFERENCES WITH THE REPRESENTATIVES AND COMMITTEES ON ALL BRANCHES OF THE INDUSTRY, LASTING OVER MANY DAYS, AND THE COMMISSION ITSELF SPENT MANY HOURS IN CONFERENCE WITH THESE REPRESENTATIVES, considering their various ideas and recommendations and reviewing their extensive written suggestions. This is in addition to the many hours which the full Commission has spent with the staff. The suggestions of the industry have thus been thoroughly canvassed and we have given careful consideration to all of their objections and suggestions.

I HAVE NOT LEARNED THAT THERE IS A SUBSTANTIAL OPPOSITION OF THE INDUSTRY TO THE IDEA OF FEDERAL REGULATION. I do not mean by this that the representatives of the industry have approved the Bill. We made known our willingness to discuss it with them in detail after it was introduced but with a few special exceptions, they have not chosen to accept our invitation. I gather from the press that there are various sections of the Bill to which objection is made. Personally, I regret that after the Bill was printed the industry did not see fit to confer with us.

THE OBJECTIVES OF OUR PARTICIPATION IN THESE HEARINGS IS TO LAY BEFORE THE CONGRESS, IN ADDITION TO THE PRINTED REPORTS, WHICH BUSY MEMBERS DO NOT ALWAYS FIND THE TIME TO STUDY IN DETAIL SUCH INFORMATION AND RECOMMENDATIONS AS WE HAVE. We realize fully, that the enactment of a bill is a responsibility of the Congress, and not of the Commission. It is our responsibility to lay before you as frankly and as fairly as we can the facts which we have gathered and the views at which we have arrived.

OUR PLAN OF PRESENTATION IS THAT AT THE CONCLUSION OF MY STATEMENT VARIOUS MEMBERS OF THE STAFF AND INDIVIDUALS NOT CONNECTED WITH THE COMMISSION, WHOM WE WILL SUGGEST THAT YOU CALL, WILL TRY TO "HIGH-SPOT" AND EPITOMIZE THE OUTSTANDING FACTS WHICH HAVE BEEN DEVELOPED IN VARIOUS SITUATIONS. A brief synopsis -- too brief, I fear, -- of the statistical analysis will be presented.

WE TAKE NO SPECIAL PLEASURE IN PARADING BEFORE THIS COMMITTEE THE UNWINDSOME REMNANTS OF THE EVIL OR CARELESS DEEDS OF SOME OF THE INVESTMENT TRUST SPONSORS AND MANAGERS. We do it because it seems necessary to do it, in an effort to prove the need of regulation and to give the Committee an adequate basis upon which to form a judgment on the differences of opinion between the Commission and the industry, which will be made known as these hearings progress. I personally am convinced that without legislation which approximates this Bill, the abuses and deficiencies in the industry as a whole will not be eliminated.

WE SHALL ALSO CALL TO THE ATTENTION OF THE COMMITTEE VARIOUS FILLS IN EQUITY WHICH THE COMMISSION HAS BROUGHT AGAINST VARIOUS INVESTMENT COMPANIES TO ENJOIN THE SALE OF SECURITIES OF TRUSTS BY METHODS WHICH ARE, TO SAY THE LEAST, QUESTIONABLE. Some of them went to trial. More of them resulted in consent injunctions. We didn't ask them to consent; I assume they consented because they wanted to. The Commission has also had a number of stop orders against companies which have registered, or attempted to register, under the Securities Act of 1933. They will be described by members of the staff of the Commission. We shall also bring to the attention of the Committee a number of criminal cases, some of which grew out of the Commission's investigations, some of which are still pending and some of which have resulted in convictions.

I WOULD LIKE TO STATE IN A VERY GENERAL WAY WHAT THE OBJECTIVES OF THE LEGISLATION ARE. The details of the legislation will be discussed by the various members of the staff who are more familiar with the technical details than I am.

First of all, we realize, as I have already stated, that the Bill is the responsibility of Congress. I have seen enough of the legislative process to know that bills, like plays, are not written but rewritten. At the same time, I believe that this Bill is a reasonable and a fair Bill. My personal opinion is that some provisions are somewhat too lax. The mildness of many of its provisions has provoked approval in some quarters and criticism in others. We want to be fair and reasonable to the industry; we also want to be fair to investors.

IN GENERAL, VARIOUS COMMENTATORS, WITHOUT APPROVING OF ALL THE DETAILS OF THE BILL, HAVE SAID THAT IT GIVES THE GENERAL IMPRESSION OF A MILD AND WELL-CONSIDERED MEASURE. Among these may be noted "The New York Times," "The Christian Science Monitor," and "The St. Louis Post Dispatch."

BEFORE I POINT OUT SOME OF THE THINGS THAT THIS BILL DOES, I SHOULD LIKE TO POINT OUT SOME OF THE THINGS THAT IT DOES NOT DO.

IN THE FIRST PLACE, THE BILL DOES NOT ATTEMPT TO SET UP AN IDEAL FORM OF INVESTMENT COMPANY AND THEN COMPEL ALL COMPANIES TO CONFORM TO THE IDEAL. ITS PROVISIONS HAVE BEEN SCRUPULOUSLY ADAPTED TO THE EXISTING DIVERSITIES OF INVESTMENT COMPANY ORGANIZATIONS AND FUNCTIONS.

IN ORDER THAT THE COMMITTEE MAY FULLY APPRECIATE THE VARYING FORMS WHICH INVESTMENT TRUSTS AND COMPANIES TAKE, LET ME BRIEFLY DESCRIBE THE VARIOUS TYPES.

FIRST THERE ARE THE MANAGEMENT INVESTMENT COMPANIES. The distinctive feature of these companies is that no restrictions, or only limited restrictions, are imposed with respect to the nature, type and amounts of investment which their managements may make.

MANAGEMENT INVESTMENT COMPANIES FALL INTO TWO BROAD CLASSES, THE OPEN-END AND THE CLOSED-END TYPE. The peculiarity of open-end companies is that they issue so-called redeemable securities -- that is, a security which provides that the holder may tender it to the company at any time and receive a sum of money roughly proportionate to the current market value of his share of the company's assets. Because of the exercise of this redemption feature, the assets of most open-end companies would constantly be shrinking if they did not constantly sell new securities to new investors. It is because of this constant sales activities that these companies are called "open-end" companies. Presumably, the name was suggested by the familiar term "open-end mortgage." Closed-end companies are management investment companies which do not have this redemption feature. They do not distribute their securities continuously but only from time to time as they need new capital. Up to 1920 nearly all investment companies were of the closed-end type. However, the open-end companies though a relatively recent development, have expanded rapidly and now have total assets whose value is approximately two-thirds of the value of closed-end assets.

THEN THERE ARE THE FIXED OR SEMI-FIXED INVESTMENT TRUSTS. In this type management discretion is completely or almost completely eliminated. The investor is sold an undivided interest in a specified package or unit of securities which are deposited with a trustee. The underlying securities can not be changed at all, or can be eliminated only upon the happening of certain specified contingencies, such as the passing of a dividend on any security in the package for a prescribed period of time, the reduction in the investment rating of the security by a prescribed statistical service and similar reasons.

ANOTHER TYPE OF INVESTMENT COMPANY IS THE SO-CALLED INSTALLMENT INVESTMENT OR PERIODIC PAYMENT PLAN, WHICH IS IN ESSENCE A DEVICE TO SELL INVESTMENT TRUST OR INVESTMENT COMPANY SHARES TO THE PUBLIC ON THE INSTALLMENT PLAN. These plans were designed to tap the savings of individuals in the lowest economic and income strata of the population for investment in common stocks. Some plans provide for installments as low as \$5 a month but the usual payment is \$10 a month and the period of payment is generally 10 years.

THE FINAL VARIANT OF INVESTMENT ENTERPRISE STUDIED BY THE COMMISSION IS THE SO-CALLED FACE-AMOUNT CERTIFICATE COMPANY. Although these companies have been in existence in this country since 1894, the greater portion of their certificates have been sold since 1929. In essence the certificates sold by those companies are contracts between the corporation which issue them and the purchaser, whereby in consideration of the payment of certain specified installments the corporation agrees to pay to the purchaser at maturity a definite sum, the "face amount" of the certificate; or to pay prior to maturity a specified surrender value of the certificate. As in the case of installment investment plans, the selling commissions or "load" on the face amount certificate are taken out of the installments paid within the first and second years. As a consequence, the surrender value of the certificate during the early years is small and the investor who defaults or permits his certificate to lapse sustains a substantial loss. Though there are relatively few companies in this field, they are very large. The two largest companies and their subsidiaries have aggregate assets in the neighborhood of \$190,000,000 and have outstanding certificates with a face amount of over \$1,000,000,000--the amount which these companies will have to pay if all investors make the required payments.

THE BILL DOES NOT ATTEMPT TO TELL INVESTMENT TRUSTS THAT THEY CAN OR CANNOT ENGAGE IN THIS OR THAT ACTIVITY. There is not the slightest conscious effort to circumscribe or restrict the initiative or the enterprise of managers. The Bill does not attempt to say to the investment trust, "You cannot make this or that kind of an investment." It does attempt to say, "If you regularly make this or that kind of an investment you must make disclosure and obtain your stockholders' consent to this fundamental business; you must wear the label appropriate to your business; and you must conform to the type of regulation that is most appropriate for your kind of a company."

For example, the bill does not prohibit investment companies from actively trading in securities or engaging in underwritings. However, we feel very definitely that a company which risks a substantial part of its capital in underwriting, or a company whose principal business is to speculate actively should be clearly labelled as such a company and should have the consent of its security holders to engage in these activities.

THE BILL DOES NOT ATTEMPT TO COMPEL INVESTMENT COMPANIES TO CHANGE THEIR EXISTING OUTSTANDING CAPITAL STRUCTURES OR TO SIMPLIFY THEIR EXISTING PYRAMIDED INVESTMENT COMPANY SYSTEMS. It does provide, however, that in the future these companies shall issue only common stock, except in connection with consolidations, mergers and reorganizations.

NOR DOES THE BILL REQUIRE THE SEGREGATION OF INVESTMENT BANKERS, BROKERS AND DISTRIBUTORS FROM THE MANAGEMENT OF INVESTMENT COMPANIES, A STEP WHICH VARIOUS OFFICIALS OF INVESTMENT COMPANIES ADVOCATED IN THE HEARINGS BEFORE THE COMMISSION. However, to prevent the evils which may result from the divided loyalties, certain specific restrictions are imposed on affiliations involving conflicts of interest.

THE BILL DOES NOT PROHIBIT MANAGEMENT CONTRACTS ALTHOUGH THERE WAS EXPRESSED BY MANY OFFICIALS THE OPINION THAT THEY SHOULD BE ABOLISHED. IT DOES REQUIRE THAT MANAGEMENT CONTRACTS MEET CERTAIN SPECIFIED CONDITIONS.

UNDOUBTEDLY, BEFORE THE HEARINGS ARE OVER, THERE WILL BE CONSIDERABLE DISCUSSION, AND PROPERLY SO, AS TO THE AMOUNT OF DISCRETION WHICH SHOULD BE GIVEN TO THE COMMISSION. My immediate observation is about as follows;

First of all, it seems to me that the greatest virtue of the administrative process is flexibility. I think it would be unfortunate to throw it away, A good deal of the criticism of it is based upon the false idea that the rule-making power is the power to make laws. We do not have the power to make laws. No one has the power to make laws except Congress. The Schechter decision by the Supreme Court reminded us of that fundamental principle. Congress may lawfully, however, delegate the right to make rules to implement already existing laws according to prescribed standards. Despite the views that I have expressed, if Congress believes that it can write flat prohibitions into this statute which will stamp out abuses and which will not do injustice to the honest persons in the industry, that's all right with us. The fewer discretionary decisions we have to make, the easier our administrative job is. I shall not be surprised, however, if as the hearing develops you find situations where rigid prohibitions cannot be drawn and where the industry and the Senators will find that it is necessary to put a little rubber into the Bill for the exceptional, unforeseeable and unpredictable cases. For example, I doubt the wisdom of undertaking to write into the Bill itself uniform accounting standards for all investment trusts. It isn't a job that I would relish very much. There is, it seems to me, but one sensible way to approach problems of that nature. Give the power to the Commission and then let the Commission work it out in conference as a joint enterprise with the industry and the representative accounting firms and societies of the country. I assume, of course, that the Commission should be given the power to promulgate rules relating to its own practice and procedure.

It seems to me that in the face of problems of that kind and of practical necessities that it is unwise to take all flexibility out of the Act. I doubt whether the Committee can solve these difficult problems by the rigid rules of statute. I doubt whether the industry believes it can be done. By way of illustration, I would like to say from actual experience that if the Securities Exchange Act of 1934 had not given us very flexible powers of exemption, the utmost confusion would have existed in the early days of registering stock exchanges and the thousands of listed securities traded on those exchanges. We had to resort to this exemptive power for a temporary period in order not to interrupt trading and in order to finally reach the statutory objective of registration. Indeed, much of the flexibility of the Exchange Act is due to the insistence of the exchanges themselves, as the reports of the Congressional Committees clearly show (see, e.g., H.R. Rep. No. 1383, 73d Cong., 2d Sess., pp. 6-7).

NOW WITH RESPECT TO THE SUBSTANTIVE PROVISIONS OF THIS BILL. I DO NOT PROPOSE TO DISCUSS THESE IN DETAIL, BUT I DO WISH TO MAKE TWO OR THREE GENERAL OBSERVATIONS ABOUT THEM.

IN GENERAL, EVERYONE SEEMS TO BE PRETTY MUCH AGREED THAT THE FUNCTIONS OF INVESTMENT TRUSTS SHOULD BE TO AFFORD THE SMALL INVESTOR AN OPPORTUNITY TO SPREAD HIS INVESTMENT RISKS BY A DIVERSIFICATION OF SECURITY HOLDINGS, TO FURNISH COMPETENT AND CONTINUING INVESTMENT SUPERVISION, AND TO ASSIST IN MAKING CAPITAL AVAILABLE FOR INDUSTRY. In a great many instances these objectives have not been realized. The failure may be attributed to certain fundamental causes.

FIRST, THERE HAS BEEN NO REGULATION WITH RESPECT TO THE INDIVIDUALS WHO MAY ORGANIZE AND OPERATE THESE COMPANIES. The Bill provides for the registration of officers, directors, managers, and underwriters of investment trusts and companies. That does not mean that no one can occupy one of these positions unless his qualifications are approved by the S.E.C. The Commission would only have the authority to deny registration or revoke registration for certain specific causes, viz: (1) that the man had been convicted of a crime within ten years; (2) that he is under injunction by a court of competent jurisdiction because of some wrongdoing in connection with security transactions; (3) that in his registration he makes a material misrepresentation to the Commission. The purpose of this provision is to prevent persons with unsavory records from occupying these positions where they have so much power and where faithfulness to the fiduciary obligation is so important.

SECOND: IT IS PERHAPS NOT TOO MUCH TO SAY THAT THE DISREGARD OF FIDUCIARY STANDARDS LIES AT THE ROOT OF MANY INVESTMENT COMPANY PROBLEMS. THE FIDUCIARY OBLIGATION OF THE MANAGEMENT TO STOCKHOLDERS IS TOO OFTEN VIOLATED OR DISREGARDED. The Bill undertakes to impose specific conditions which will insure the observance of this fundamental obligation.

THIRD: MANY INVESTMENT COMPANIES HAVE ADOPTED COMPLICATED AND PRECARIOUS FORMS OF CAPITAL STRUCTURE. Under this Bill they will be required to follow more conservative standards. In view of the nature and functions of these companies, I believe that there is no excuse for pyramiding or for more than one class of securities in their capital structures.

FOURTH: ADEQUATE ACCOUNTING REGULATION IS IN MY OPINION FUNDAMENTAL, if these companies are ever to serve the purposes for which they should be designed.

FIFTH: SOME PUBLIC SUPERVISION OVER MERGERS, CONSOLIDATIONS, AND OTHER REORGANIZATIONS IS NECESSARY FOR THE PROTECTION OF INVESTORS. The investor is singularly helpless under such circumstances.

THIS BILL WILL, I BELIEVE, PROMOTE THE DIGNITY OF INVESTMENT TRUSTS. THE MANAGEMENT OF THESE INSTITUTIONS IS WORTHY OF BEING A SEPARATE PROFESSION AND A SEPARATE CHARGE IN ITSELF, INSTEAD OF BEING A MERE ADJUNCT TO SOME OTHER LINE OF BUSINESS. What we ought to develop is a group of expert investment trust managers who do not make their profits from originating and distributing types of securities, styled principally for their sales appeal, but from wise and careful management of the funds entrusted to them.

I BELIEVE THAT A TRUE MUTUAL INVESTMENT COMPANY SUBJECT TO GOVERNMENTAL SUPERVISION MAY BE ENTITLED TO SPECIAL TAX CONSIDERATION. At the present time, only open-end companies are the beneficiaries of this consideration. I feel that the basis of granting this favorable tax treatment should not depend upon the right of a security holder to compel the company to redeem his security but rather upon the more fundamental aspects of mutuality and regulation.

INTELLIGENT REGULATION IS IN THE INTEREST OF THE INVESTMENT TRUSTS AND COMPANIES THEMSELVES, AS WELL AS THE PEOPLE WHO PUT THEIR MONEY INTO THESE ORGANIZATIONS. I believe this bill will tend to restore public confidence in these institutions. These organizations could then perform the vital functions of furnishing honest and unbiased investment management to the large group of small investors who require this service. These organizations might then become a vital factor in furnishing capital for industry and the stimulation of national recovery.

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