

the person who has an interest in the contract should not be counted in a quorum, and that his votes do not count.

Subsection (e) applies to this situation: You have these investment company systems like United States Electric Corporation—and we have others. In that situation we have made provision for mutualizing the management. In some situations what happens? The sponsors of the top holding company have the common stock of the top holding company. The top holding company acts as investment counsel for the lower companies, so that the top holding company is making money on the lower companies because of the management fees it is charging the lower companies. The “insiders” or the sponsors having the stock in the top company benefit in that way from the management fees charged the lower companies.

In that circumstance we say that provision ought to be made for a mutual management company which will manage all the companies in the system and allocate the cost equally throughout the companies, based upon the amount of assets of each company. The fact of the matter is the Tri-Continental Corporation, as I understand it, only recently formed a mutual investment company to service all the companies in its system.

Section 16 deals with changes in the board of directors, and is precisely the provision contained in the banking law of the State of New York which says that you cannot elect more than one-third of the board of directors in-between meetings of the stockholders.

The fact is that in every case that we saw where there was a transfer of the control of an investment trust, the procedure that was used was—what? Let me say, here, this is one of the reasons why the stockholders were kept in ignorance of changes or transfers of control. In the Continental Securities case they could not have accomplished their purpose if it had not been for the fact that at the time when they bought the controlling block of stock, one of the members of the incumbent board of directors resigned, and a new man was elected. Then another one resigned, and another new one was elected; and then another one resigned, and a third one was elected. So, through this form of seriatim resignations and elections, the whole board of directors was changed in 5 minutes.

We say—and that is precisely what the New York banking law says—that if the board of directors which was elected by the stockholders is going to change substantially in complexion, then the stockholders ought to have something to say about who shall be the new directors. However, we can visualize situations, because of emergencies, death, sickness, resignation, where you ought to be able to change up to one-third of the directors without the vote of the stockholders. That is section 16.

Senator TAFT. Mr. Schenker, I do not want to interrupt; but because of the fact that I was in the Senate at 2:30, perhaps I have missed something of your explanation.

What is the reason for limiting the size of an investment company as you propose to do in section 14? What are the present sizes? Does that affect any existing companies?

Mr. SCHENKER. No, Senator; the nearest one to that is an open-end company which itself has \$120,000,000, and another company which is under the same management, which has \$10,000,000—which in the aggregate makes about \$130,000,000.

Senator, may I make this observation: When you say this limits the size, that may not be a precise description of the effect of this section. What we say, Senator, is that if you have \$150,000,000 of assets, there is nothing in the world to prevent you, through your expert management, from going to \$2,000,000,000. We say that at the time when you have \$150,000,000 of assets, you cannot raise new capital through the issuance of new securities.

So if you started with \$10,000,000 and went to \$3,000,000,000 through appreciation in assets, this section does not even remotely touch you.

Senator TAFT. I mean why do you hit on \$150,000,000 or \$200,000,000? Is it just the idea that they ought not be too big; is that the idea?

Mr. SCHENKER. It is the idea that they ought not be too big—the idea that \$150,000,000 in an investment company is a bigger common-stock pool than the 49 largest insurance companies of this country have in the aggregate.

Senator TAFT. In common stock?

Mr. SCHENKER. In common stocks.

May I just read this one thing, Senator?

Senator TAFT. If you have already done so, do not do it again, of course.

Mr. SCHENKER. Yes; but I have not done this, and I think you will be interested.

Senator TAFT. Yes.

Mr. SCHENKER. When we come to the companies which are open-end companies, where the stockholder has a right to tender his stock for redemption, where you can get situations which correspond to runs on banks, and where these types of companies have to invest in concentrated blocks of common stock, you have two situations: You may very substantially affect the securities markets in those situations, you may also create a situation where the fellow who gets in first may get his money, whereas the fellow who comes in later may not.

You take the very company that I am talking about, which has assets of \$120,000,000: Mr. O. O. Sprague, who was financial adviser to various administrations of the Government, is on the board of advisers of that company. We asked his opinion on size. Practically the unanimity of opinion is that when you get up to \$100,000,000 you have a man-size job because you have practically a blind account. There is no limitation on how fast they can turn over their portfolio or how concentrated their blocks can be, and so forth, except for the limitations specified for a diversified company.

What did Mr. Sprague say?

Has any size been discussed, Mr. Sprague, any limitation of size?

Not very definitely. I think there was a vague feeling at one time, long before we had reached a hundred millions, that perhaps a hundred million dollars was about as high as any trust might well go.

And is that your personal feeling?

Oh, I would not like to fix it upon any particular figure, and if it were a very slow accretion I do not know but that I should be prepared to contemplate going to \$150,000,000.

Whereas if we were to secure 50 millions in the next 15 months, I should greatly regret it.

And you would feel that that was perhaps a little too big to be readily handleable?

Yes; if you have a large amount of new money coming in each week, I think it is rather probable that it does affect your handling of your existing portfolio a little. You won't quite so readily, perhaps, sell something if you have got a half million or so of new money already there to invest, that week.

The fact of the matter is that in Great Britain the average investment in an investment trust is \$30,000,000.

In the situation in England, where they have common management for a group of investment companies, we do not know of any instance where the group's assets exceeded \$100,000,000. Of course there is an arbitrary element in that. Maybe that should be \$175,000,000; maybe it should be \$125,000,000. We took \$150,000,000 because we did not want to touch any present situation.

The fact of the matter is that this company has a ceiling of \$30,000,000, and if the company can grow to \$30,000,000 through their management, more power to it.

Section 17 has to do with transactions of certain affiliated persons and underwriters.

I was interested in your observation, Senator, about affiliated persons. I was afraid that some time you would take a look at this and become a little frightened. Maybe if I explained it it will not seem so awesome.

The only thing this section says is that a person who is an officer, a director, a manager, or underwriter, shall not as principal sell any property to the investment trust. And that is obvious, because where he is attempting to sit on both sides of a transaction, where he has a personal pecuniary interest as a seller and is acting in a fiduciary capacity with respect to the investment trust—

Senator WAGNER. You have had some instances of that, have you not?

Mr. SCHENKER. Yes. I am not saying that it is going on to the same extent now as it did in the past, but it still happens; and I do not think the industry takes any umbrage at this particular provision.

In the case of Iroquois Share Corporation the brokerage firm which managed the investment trust, at the bottom of the real estate market, sold a building up in Buffalo to the investment trust for \$313,000, which was exactly what it cost. The investment company bailed them out of the real estate.

Senator WAGNER. It was a bailing out, was it?

Mr. SCHENKER. Yes.

There was another situation in Buffalo. Niagara Share Corporation was sold a distributing agency in 1932 by its managers who bought the distributing business back later. That may have been fair; we do not know. But we say under the circumstances that we do not think an officer or director ought to be willing to put himself in the position where he is sitting on both sides of the table. He cannot knowingly sell property to the trust. He cannot knowingly purchase property from the trust; he cannot borrow any money from the trust. If I had the time, if the Senate committee is interested, to give you the figures of the aggregate amount of loans made to officers and directors of investment companies, it would be of interest.

The fourth one is that if affiliated persons go into a joint enterprise with an investment trust they cannot do it in contravention of such rules and regulations as the Commission shall formulate to insure fair dealing and no overreaching.

Possibly the only elaboration that this requires at the present time is an explanation of what is an affiliated person.

You see how easy a provision like this would be of circumvention if we said that an officer cannot sell. Then suppose his partner sells, or his partnership sells, or he organizes a personal holding company, which makes the sale.

So an affiliated person is nothing but an officer or director or any partner of his in a firm in which he is a partner. Also no corporation which he controls can sell any securities or property directly to the investment trust.

In order to make sure that there is no injustice done, you will notice that the statute says specifically "shall knowingly sell." That is to take care of cases of good faith and inadvertence.

Subsection (b) presents this situation. I think I can best illustrate it with a case. Take the Atlas Corporation. It has a controlling interest in Bonwit Teller, a department store in New York. It has also a controlling interest in Franklin Simon, another department store in New York. What we say is this: If the Atlas Corporation wants to sell Bonwit Teller to John Wanamaker, it should be no business of the Securities and Exchange Commission. You have two people there who can take care of themselves—John Wanamaker and Floyd Odlum. However, if the Atlas Corporation wants to sell Bonwit Teller to Franklin Simon—where the Atlas Corporation has a controlling interest in both companies, but there is a separate and distinct public interest in each one of the corporations—then in that event you have not got an arm's length dealing. In those circumstances the transaction should be subject to the scrutiny of some independent agency as to its fairness.

Mr. Floyd Odlum has testified and has said that so far as he is concerned—and he said it repeatedly during the course of the investigation, and I think he would be prepared to say it if he were called—that he would welcome the institution of an agency to which he could come down and say, "I am in this conflicting position. I control both these situations, but there is a big public minority interest in one and there is a big public minority interest in the other. You take a look at it and tell me if it is fair, if it is all right."

SENATOR TAFT. You have an investment trust getting a minority interest in two other concerns?

MR. SCHENKER. It takes a majority interest in two.

SENATOR TAFT. Control in two different companies?

MR. SCHENKER. Yes.

SENATOR TAFT. And the question is whether they shall sell one company to another company in which they have an interest?

MR. SCHENKER. That is right. This relates not to the sale of merchandise. If Bonwit Teller wants to sell some dresses, that is all right. But if the Atlas Corporation wants to take its holdings in the Bonwit Teller Co. and sell them to the Franklin Simon Co., so that Franklin Simon would control Bonwit Teller, since the Atlas Corporation controls Bonwit Teller and controls Franklin Simon, it is sitting on both sides of the table.

SENATOR TAFT. And the purpose of the Securities and Exchange Commission is to fix the price.

MR. SCHENKER. No; that is not it.

SENATOR TAFT. Who is to fix the price?

MR. SCHENKER. We have tried to set forth, Senator—and, again, I am not unmindful that it is a difficult problem—the precise things which should be considered in such a situation.

Senator TAFT. Supposing an individual owns a majority interest in both companies: Why should we legislate about it, when you have a long series of common law decisions as to what a majority stockholder can do and cannot do? What difference does it make whether it is an investment trust or a rich man? I mean, what has it got to do with the stockholders of an investment trust?

Mr. SCHENKER. In the first place, the rich man has his own money through which he can control one company and the other. In the investment company situation the fellow who controls the investment company may have no interest in the company, exercises control not through his own money, but through the public's money.

With reference to the hypothetical situation which you gave me, I am not sure whether you include as a fact that the rich individual had—well, here [indicating on sketch] is the rich individual. Does he own a controlling interest in "A"?

Senator TAFT. He owns a controlling interest in "A" and also in "B," and he wants to sell "A's" assets to "B." There is a long series of common-law rules as to whether he can or not. He has to be pretty careful, undoubtedly. If the minority votes against him he is certainly taking a chance on the thing. Which one are you trying to protect? Are you trying to protect the stockholders in the investment trust?

Mr. SCHENKER. There are two aspects, Senator. There is the protection of the minority stockholders, and then there is the protection of the investment company, because the particular transaction may redound to the benefit of one class of security holder and not to the other. But if the controlling person who controls the investment company, who does not control it by virtue of his own money invested in it—that is, he does not control both the department stores through his own money but through the investment company's money—then we say that under those circumstances the whole thing ought to be subject to scrutiny.

Senator TAFT. I do not quite see, though, just where the conflict of interest lies.

Mr. SCHENKER. The conflict is between those minority stockholders of the two department stores.

Senator TAFT. You are branching out a long way when you are trying to regulate investment trusts, trying to protect minority holders in investment companies.

Mr. SCHENKER. This may be a closer case and may be more analogous to your situation, Senator. Take the situation where you have intercompany transactions, where one investment trust may sell securities to another in the same system. In those circumstances you have the problem whether or not that particular sale redounds to the benefit of the controlling person who may be a common-stock holder. You have that complex situation where you have intercompany transactions, where those intercompany transactions are really involving public funds but are in the control of an individual who may have an interest in the whole picture only through ownership of common stock. That transaction may not be for the benefit of the debenture holders or the senior security holders. There is a variety of intercompany transactions.

Let me give you another example, Senator. There may be a great deal in what you say. Here is an actual case. The Phoenix Securities Corporation owned a 20-percent interest in Celotex Corporation. It

also owned approximately a 20-percent interest in Certain-teed Products Corporation. About a year or 18 months ago the Phoenix Securities Corporation had the Celotex Corporation buy Phoenix's holdings in Certain-teed at one-half million dollars premium above market.

They were on the three sides of the transaction. It is true, Senator, that after we held a public examination upon it, a stockholders' action was instituted.

Senator TAFT. I would think so. Any lawyer in Cincinnati would institute it in a hurry. The only question, to me, is the publicity.

Mr. SCHENKER. The publicity, Senator; and there is no greater believer in the prophylactic effect of sunlight than I am; but the unfortunate thing is that unless there is an agency that goes in with a flashlight, the stockholder never gets the publicity.

That was true in this transaction. We saw that there was some contemplated transaction in which these people were going to sell their Certain-teed stock to Celotex at a half million dollars premium above market. Certain-teed was not doing so well. I am not saying it was not a good deal. It may have been. They were not unrelated industries.

Senator TAFT. They may have had some interlocking directors that I do not know about. But the same abuse could be conducted by an individual. Again, this is a case where you meet the problem of corporation laws which are inadequate in many cases to protect minority stockholders. But we cannot protect them very far by regulating investment trusts. We just scratch the surface.

Mr. SCHENKER. The only distinction between your hypothetical case and mine, Senator Taft, is that one is an individual and the other is a holder of public funds.

Mr. HEALY. Would not section 17 (a) (1) operate, for example, to forbid Mr. Floyd Odlum from selling property to the Atlas Corporation? Would it, Mr. Schenker?

Mr. SCHENKER. That is right.

Senator TAFT. Who is he?

Mr. SCHENKER. He is the president of the Atlas Corporation.

Mr. HEALY. There is a prohibition against his selling property to the Atlas Corporation in section 17 (a) (1). That is an out and out prohibition. Then the effort was made—I do not know whether wisely or not—to permit it after it passed the scrutiny of an agency such as the S. E. C. But here is the "rubber" in the statute, either in subsection (b)—I was not strictly accurate. (b) applies to inter-company transactions, and not to the case of individuals. But, at any rate, it represents, as I understand it, a means of establishing an exception to the prohibitions that are established in the earlier parts of the section.

Senator TAFT. Passing over the examples given, they do not seem to be quite the same as this. You mean that the object of this section is to prohibit a man from selling his own securities or the securities of a company which he controls, to the investment trust itself?

Mr. SCHENKER. Yes.

Senator TAFT. That is the main purpose?

Mr. HEALY. That is one purpose.

Senator TAFT. That is the underlying purpose. But you say that he may come to the S. E. C. and have that Commission conduct an

examination, and they may approve of his selling to the Atlas Corporation. Is that the effect of (b)?

Mr. SCHENKER. No, Senator. We feel it is analogous to the situation where an individual who is in control or managing or is an officer of the corporation tries to sell his property as principal to investment trust. Then we say that if one investment trust dominates the other investment trust, he should not be able to sell securities to the dominated investment trust without any scrutiny.

Let me give you an example, Senator.

Senator TAFT. Maybe they should not be allowed to sell it at all.

Mr. SCHENKER. The fact of the matter is that there is some sentiment in the industry to show—

Senator TAFT (interposing). I do not see why they could not go to the stock exchange to buy them.

Mr. SCHENKER. The fact of the matter is that I discussed this with Mr. Hoxsey of the Stock Exchange, and he is outraged when he sees one investment trust controlling another and selling securities to that investment trust.

The first type of example I gave was a variant of it; but if you take a situation which is analogous to an individual selling to an investment trust, you have one investment company controlling another and selling securities to the controlled investment company. Maybe it ought to be prohibited entirely.

Senator WAGNER. That is not the instance of the two department stores. They were owned by one investment trust.

Mr. SCHENKER. That is another situation.

Senator WAGNER. I have been trying to pursue that.

Mr. SCHENKER. In 1929 the Eastern Utilities Investing Corporation issued \$38,000,000 of debentures to the public. There was a \$6,000,000 banking commission, and the bankers wrote out a check for \$32,000,000 and turned it over to the Eastern Utilities Investing Corporation controlled by a Hopson group of directors. The Associated Gas and Electric Co. controlled the Eastern Utilities Investing Corporation. So you had Hopson on the board of directors of the Eastern Utilities Investing Corporation and Hopson on the board of directors of the Associated Gas which controlled the Eastern Utilities Investing Corporation. Although the prospectus said, "We are going to use this money to buy \$32,000,000 of diversified securities," they did not even bother to deposit the check, but endorsed it right over to the Associated Gas. Instead of buying Consolidated Gas and various other utilities, Associated Gas sold to Eastern Utilities Investing Corporation \$32,000,000 of Associated Gas stock.

That is analogous to a situation where an individual controls an investment company and sells stock to the investment company. Is not that analogous to a situation where one investment company controls another and sells it securities?

Maybe that sort of a situation ought to be prohibited, just like the individual is prohibited. We feel that there may be circumstances in intercompany situations where it might be unobjectionable. That is one of these "rubber" sections that I think the industry does not object to, Senator.

Senator TAFT. An affiliated person includes any person owning 5 percent or more of the outstanding voting securities. That makes the definition of an affiliated person, does it?

Mr. SCHENKER. Paragraph (18) on page 90 provides (reading):

"Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, or co-partner of any such person.

That means an officer, director, any partner of his in a partnership, and any company of which he is a 5-percent owner.

Senator TAFT. Frankly, it would take all afternoon to study section 17 to find out what it means, before I begin to criticize it. You define what would be an affiliated person, or any affiliated person of such a person acting as principal; and then you say that no affiliated person of an affiliated person of a registered investment company shall sell any stock to the company. Is that the English of it? It is certainly pretty hard to understand what this section does prohibit and what it does not.

Mr. SCHENKER. What we tried to say—and it is a little complicated—is that no officer, director, or controlling person, no partner of his in a firm in which he is a partner, and no company which he controls, shall have the right to sell property to the investment trust.

Otherwise it would be very easy of circumvention. If he wants to sell some property to an investment trust he will not sell it personally; he will organize a personal holding company and put the property in the name of that company and have it sell the property.

The use of the term "affiliated person" is an attempt in a shorthand way to spell out those situations that I have enumerated. Maybe we have not said it, but I think we have.

Senator TAFT. If you have on the board a man who owns a 5-percent interest in another company, he is an affiliated person of that company?

Mr. SCHENKER. He would be an affiliated person of the investment trust, and the company would be an affiliated person of his.

Senator TAFT. That company in which he owned 5 or 6 percent of the common stock could not sell any securities to the investment trust?

Mr. SCHENKER. That is right.

Senator TAFT. Does it go beyond that? Does it go to an affiliated person of that company or some other person who owns 5 percent of that company's stock, and provide that he could not sell either? Is it to the second degree?

Mr. SCHENKER. He could sell it. We tried to get the situations where it would be to his pecuniary interest to unload securities on the investment trust. We figured that if he had a 5-percent interest in the company that is selling the securities, then he has a sufficient interest to affect his judgment, and therefore we say that he cannot sell.

Senator WAGNER. He is a director of the trust?

Mr. SCHENKER. Yes; by virtue of the fact that he is a director, he is an affiliated person of the trust; and by virtue of the fact that he owns 5 percent of the securities of the company that is going to sell property to the trust, that company is an affiliated person of his. That is why we say "an affiliated person of an affiliated person."

Senator WAGNER. You go one step farther, and provide that a copartner cannot sell either?

Mr. SCHENKER. That is right.

Senator WAGNER. You do go that one step farther?

Mr. SCHENKER. Yes, sir.

Section 17 (c) provides that a person may sell merchandise in the ordinary course of business to any affiliated company of a registered investment company if such affiliated company is not itself an investment company. That does not apply to ordinary merchandise sold in the ordinary course of business.

Subsection (d) of section 17 says, in substance, that an affiliated person or any affiliated person of an affiliated person can act as an agent and receive compensation in any transaction except in the brokerage case.

You might say, Why did the Commission write that? That is because we found cases where although the controlling person did not sell any property to the investment trust, he was a real estate agent in the transactions in which real estate was sold to the investment trust, and we feel under those circumstances that he has this conflict of interest. But he can act as the broker for the trust and he can act as the underwriter or the distributor of securities.

Subparagraph (2) says that if he is going to act as a broker he may get the ordinary stock exchange brokerage commission.

Mr. HEALY. I want to say one word there. I am not sure that that provision should not be restricted by having a corresponding provision for over-the-counter transactions where just the ordinary going commission is charged. It may be a little bit too tight.

Senator WAGNER. Will you prepare something for the committee on that?

Mr. HEALY. Yes, sir.

Mr. SCHENKER. Subsection (e) of section 17 attempts to set forth a broad standard of conduct.

You made a suggestion originally, Senator Taft, to this effect: Why can you not set forth in this bill a fiduciary obligation and make it a crime to violate that fiduciary obligation?

When we came to draft a provision like that it presented a great many problems, because if you try to impose a trustee obligation on these managers, maybe that obligation is much too strict. A trustee in some instances may be liable for negligence. We felt that that was possibly too onerous an obligation to impose upon people who are managing investment companies. So we took the broader approach and said that if he was guilty of gross misconduct or gross abuse of trust, then he was guilty of a crime.

Of course that does not mean that the Securities and Exchange Commission has the jurisdiction to determine whether he has been guilty of gross abuse or gross misconduct or gross abuse of trust. That is a criminal offense, and criminal action would have to be instituted against him.

Senator TAFT. There is a criminal statute which covers that, is there?

Mr. SCHENKER. Yes, sir; and penalties are provided for it. The penalties are referred to in section 43 on page 84 of the bill.

Senator TAFT. Section 43 provides that any person who willfully violates any provision of this title or of any rule, regulation, or order