

hereunder shall upon conviction be fined not more than \$10,000 or imprisoned not more than 2 years, or both.

That seems rather a stiff criminal provision.

Mr. SCHENKER. I do not think it is any different from the criminal provisions in other acts, and I think it must be read in the light of the fact that there is a special provision here which relates to violation of rules or regulations which says that the mere inadvertent violation of a rule or regulation is not sufficient to impose liability. If you read the balance of it you will find it says that no person shall be convicted under this section for the violation of any rule, regulation, or order if he proves that he had no knowledge of such rule, regulation, or order.

Senator TAFT. What kind of knowledge?

Mr. SCHENKER. Under those circumstances, Senator, I think he would have to prove beyond a reasonable doubt—

Senator HUGHES (interposing). Actual knowledge would have to be proved.

Mr. HEALY. This bill says willful violation. I do not believe constructive notice would be sufficient.

Senator TAFT. He is presumed to know the law, but the facts may be different.

Senator WAGNER. It cannot be willful if he knew nothing of the law.

Senator TAFT. He does not have to know the law for it to be willful. He may inadvertently do the act, but if he willfully does it and that act is a violation of the law, he has violated the law. You are presumed to know the law. You may not know the facts. If the act is willful, it is a violation of the law, a willful violation of the law.

Senator HUGHES. I have never heard any such construction of "willful" as that.

Mr. SCHENKER. Paragraph (f) of section 17, on page 39, merely provides, in substance, that you cannot have a provision in the charter or other fundamental or basic documents giving you permission to violate any rule or provision of this act. Paragraph (2) of that subsection merely says that you cannot give yourself a broad exculpatory clause with respect to any act that is covered by this bill.

Senator WAGNER. It is a good deal like the trust indenture act?

Mr. SCHENKER. Yes, sir.

Senator WAGNER. How much longer do you need, Mr. Schenker? I will tell you why I am asking the question. The Senators will have to leave soon, because there is a vote to be taken.

Mr. SCHENKER. Why can we not finish this one, and section 18, covering capital structure?

Senator WAGNER. Very well.

Senator TAFT. Does that provision require a company to amend its existing charter? [Reading:]

After one year from the effective date of this title, it shall be unlawful for the charter, certificate of incorporation, articles of association, bylaws, or trust indenture of any registered investment company—

to do certain things. If they do not amend the charter, then they are liable to 2 years in jail and a \$10,000 fine. Are you not going a little far on that? You might provide that no charter provision shall exempt the company from the provisions of this law. But to say that it is unlawful for a charter to contain such provisions, seems to me to be going rather far.

Mr. SCHENKER. That is an excellent suggestion. But what is the effect of stating it that way? If it says that it shall not contain such provisions, what sanction do you have if they do not take them out? You can do either one of two things: You have either got to make it unlawful or say that if the charter has such provision it shall be ground for the denial of registration of the company. What sanction would you use to compel the elimination of exculpatory clauses or the elimination of any provision which authorizes them?

Senator TAFT. I would say that it would simply nullify that provision of the charter so far as interstate commerce is concerned. I do not quite see how you can do it.

Mr. SCHENKER. Your approach would be, then, Senator, that any provision which exculpates the officers and directors or tends to authorize them to effect any transaction—

Senator TAFT (interposing). No provision in the charter shall prevail over the provisions of this act. Of course you will not only have charters, but you will have State laws specifically providing that certain rules shall apply to corporations. Your setting aside those State laws would depend upon Federal jurisdiction. That just occurred to me as you were going over it.

Mr. SCHENKER. Paragraph (g) of section 17 on page 40 merely says that at some subsequent date the Commission can make rules and regulations with respect to requiring the investment companies to give the custody of their securities to a bank or trust company. There is no provision at the present time for that. That is a matter of some consequence, Senator, because—if you recall the case that Mr. Smith gave of this old New England banking firm—that banking firm, which was in control of an investment company, was a depositary of the securities of an investment company. The banking firm gave a certificate to the auditor that it had control of the securities, when the fact of the matter was that the banking firm, being broke, had hypothecated the investment company's securities with a bank for the banking firm's own personal loan.

In that same picture the banking firm needed funds. It took two or three million dollars, I forget which, from the investment company and issued its own certificates of deposit. When we looked at the balance sheet of the investment company it said "Certificates of deposit \$3,000,000." A person would assume that they had the money with the Chase National Bank, but it was the investment banking firm's own certificates of deposit that were issued.

Senator HUGHES. Why could not that be met by having the banking commissioners have control over it? Would that precaution go too far?

Mr. SCHENKER. You might get a conflict of jurisdiction between different agencies.

Senator HUGHES. Insurance commissioners have control over deposits of insurance companies.

Mr. SCHENKER. We still have not recommended that it is necessary, at least at this time, to go so far. If any abuses develop, we can come back to Congress and say that we found that situation.

Paragraph (2) of subsection (g) of section 17 says that in the future, if the situation is such that the protection of the investors requires it, the Commission may make rules and regulations with respect to bonding employees. Most of the reputable ones, in fact, nearly all of them, do have that situation. The fact of the matter is that if

there were bonds on the officials in connection with the Continental Securities Corporation they might have got part of their money back.

That is all that that provision means.

Paragraph (h) is a purely technical situation which says that the provisions of this section shall be applicable to those companies which sell investment trust certificates on the installment plan. The language of the previous part of that section is not sufficiently comprehensive to encompass that type of business. So we say that affiliated persons of these institutions shall be subject to similar provisions.

Mr. Smith would like to discuss capital structure. He may be able to clean that up pretty quickly.

Senator WAGNER. You can go on. I think the bell will ring at any moment.

STATEMENT OF L. M. C. SMITH, ASSOCIATE COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.—Resumed

Mr. SMITH. Congress told us to look into these capital structures of the various companies, and we did. We made a very careful analysis of a great many securities. We came to the deliberate, carefully considered conclusion that there should be only one class of stock for investment companies that are formed hereafter or are hereafter issued by existing companies. If they want to issue further securities, they should only be common stock.

We came to that conclusion as the result of a number of considerations, and I shall touch on some of the principal reasons, if I may. A senior security of an investment company is, in many ways, comparable with a fourth or fifth mortgage. Take, for instance, the North American Co. system, that company has quite good operating utility companies, as I understand it. There are the bonds of the operating company; then the bonds of the North American Co., which are a second mortgage, in effect; and then there are bonds of a company like Electric Shareholdings which are held in turn by Central States which, in turn, has issued two issues of debentures and four issues of preferred stock on top of that. So that those senior securities really are equivalent to fourth, fifth, or sixth mortgages.

To let a company borrow money from the public, in effect, on that type of security seems to us unsound.

Let us see what happened in Central States. In 1929 they had \$5,000,000 worth of debentures outstanding. They had \$350,000,000 of assets, mainly the stock of North American Co., which is a pretty sound holding company. In fact, it is one of the outstanding ones. Yet even with that investment up to 1939 those debentures were only worth 46 cents on the dollar. That means that the senior securities of investment companies are secured by common stock which fluctuates widely. They have terrific fluctuations and are not, in our opinion, a sound basis for the issuance of senior securities.

Take the market experience of those common stocks of investment companies; that is, the common stocks which had senior securities outstanding ahead of them. A dollar invested in those would be only worth 5 cents today, whereas a dollar invested in companies with

only common stocks would be worth 50 cents; that is, from 1929 to 1939.

That means that the common stock is speculative. It is not an investment security at all. It is a speculative security which gyrates up and down. It goes up and down three or four times as fast as the other securities.

Then, taking the senior securities, we find that as to a great many of them we have a large amount of arrearages. For instance, in 1939, out of 68 issues, 40 issues were in arrears—something like \$78,000,000. A great many of those senior securities are under water, which means that there are not enough assets to cover them.

Out of 69, there were 23 that were under water. That is not surprising when you consider that most of these investment companies are based upon common-stock investments which have decreased to about one-seventh of what it was in 1929.

So on that basis alone, if you wanted to be guided by that experience, you should not issue senior securities in an amount more than is necessary for protection, which would be in the amount of 10 percent. And that is not the only factor.

Senator TAFT. Of course, if you are relying on 1929, you should not issue any securities at all or buy them. I mean, you had an extraordinary situation. I more or less am in sympathy with the idea, but I do not see why a security up to one-third of the value is not a reasonable sort of provision. I do not like a complicated system, but, after all, some people do want a little less risk and some people want a little more risk.

Mr. SMITH. I had that approach, Senator. The more I considered the various reasons which I am going to refer to, the more I became convinced that there should be only one class. A senior security, supposedly a riskless security, has so much risk in it, has so many inherent defects, so many objections, that even one-third or 25 percent, as has been suggested, is permitting a security to be sold under the guise of the safety of seniority, when in fact it does not have it.

Senator TAFT. Of course it does not have it, but, on the other hand, you buy it only to have a larger rate of return. You might buy a preferred stock in a perfectly good utility company. Presumably, the market would adjust the rate you would have to pay on that senior security—

Senator HUGHES. Why does an investment company need other than one class of stocks, anyway? They are going to sell it to the public to get money.

Mr. SMITH. That is the point. There is no economic justification, whereas with a utility company you have real reason for it.

Senator HUGHES. You have real reason in an ordinary company; it is only to get capital.

Mr. SMITH. It is just to get capital, and we have found in a great many cases it is to get capital to establish a margin account for the common stock, and you have an inherent conflict—

Senator TAFT. I do not quite see the difference between permitting a man to buy preferred stock or a bond in a company that depends on securities and a company that depends on property and earning power. You have less chance of appreciation. On the other hand, you have a little more security. I had never thought preferred stock was a particularly good investment, but people do think so; they differ,

and I do not see the difference between an investment company and an industrial concern.

Mr. SMITH. I would like to point that out to you, because I think there is a big difference. Take the preferred stock of your industrial company. In the ordinary case you will find that they cannot issue that preferred stock until there are two or three times the coverage for it. They are right at the source of the earnings, whereas the preferred stock in the investment company is subject to all the senior charges. In the industrial company it only gets what is paid out in dividends, and those dividends over a period of years, even with capital gains, have not been sufficient to pay—since 1878 I think we figured out the greatest amount they could pay was 4 percent, assuming a 2 percent capital gain. For instance, in the year 1938, out of 71 companies examined, the average earnings were 2.47 percent.

Senator TAFT. You are just saying preferred stock is not a good investment. After all, that, it seems to me, is for the investors to decide. I do not quite see any harm done by a reasonable amount of senior securities. I do think if you limit it to a third—

Senator HUGHES. Is not the object of this legislation to look after the investing public?

Mr. SMITH. May I say, sir, if you have an established record over a period of years which shows that they cannot earn their keep, to permit people to sell senior securities on the ground that they are senior, when in fact—

Senator TAFT (interposing). I do not agree at all. Those records are open to everybody. Everybody can buy them. If you can sell that security it seems to me it is a perfectly proper thing. I do not think it is our function to say, "Here is a security which is not likely to work out—it may—so we won't let anybody sell it," even if it is not necessarily so, if the thing works out as it should. Preferred stock in an investment trust should not be sold unless you could show from the average earnings of the kind of stocks you are investing in that you have coverage for your income. You had extraordinary cases in 1929, of course, but I think sound investment in preferred stock in an investment company, unless you could show average dividends of at least twice what is needed—

Mr. SMITH (interposing). I defy you to show a single year where you can show that, and they did sell them and have sold them on the promise of capital gains. They do not disclose what the actual earnings have been. Our records show that over a long period of time they cannot earn their keep. That is just one argument. I have some more.

Senator TAFT. If we are going into the business of the S. E. C. saying that "certain securities shall not be sold because we do not think they are going to earn what they think they are going to earn," then we are going a long way beyond where we have gone before. The S. E. C. Act does not do anything like that.

Mr. SMITH. No. Of course, the Holding Company Act does, as a matter of fact, but all we are saying is that we are trying to prevent what, to my mind, seem to have been frauds on the investor. In other words, you get a gold brick that is sold and it turns out to be just a brick.

Senator TAFT. I would think that a limitation of one-third would be sufficient to protect the ordinary thing that you can foresee.

Mr. SMITH. That is not what we found according to our experience.

Senator TAFT. These things were before 1929, when it went down to one-fourth, no matter what security you bought; you lost three-fourths of your investment. You had that situation because of the tremendous drop.

Mr. SMITH. In 1929 when these securities were sold they were not earning their keep then. For instance, I have the testimony of one of these reliable banking houses that although they were paying 5 percent, they were earning only 2 percent. They said they had to go into speculative securities because they had to earn the money for the senior securities. It has that effect on the management policy.

We have found continual conflict between the senior and junior securities, where the junior securities are interested in appreciation and the senior securities are interested in safety. Yet the safety factor is entrusted to the very people who are interested in speculation.

Senator TAFT. Of course, that is true of every industrial company in the United States. Every company is run by the common stock holders, who have an interest in profits and in building up their companies and being a little more speculative than the preferred stock holders would like them to be. That is true of every company.

Mr. SMITH. I think it is more so here, because if you buy into a utility you know that that company is going to be in the utility business. You can predict on the basis of the earnings of that company over the past 20 years. You have some possibility of knowing what that company is going to do.

Senator TAFT. Not if the Government is building a plant next to you.

Mr. SMITH. Nevertheless, you have, in due deference to you, Senator—

Senator TAFT. We are considering now a bill to extend the Bonneville power lines, that will cost us \$5,000,000, paralleling two existing utility companies. There is not a company where you have not got a risk.

Mr. SMITH. In the T. V. A. area they increased their business. I think the operating companies down there had a tremendous increase since the T. V. A. came in.

Senator WAGNER. That is my understanding. If you try to change it you will hear from the people down there. Go down there and propose a change and see what will happen.

Senator TAFT. I am only saying that a utility business is subject to the same risk that an investment trust is subject to and that you have the same tendency on the part of the common stock holders to take a chance.

Mr. SMITH. You cannot change your business in the utility. In the investment company we have found them shifting overnight. Suppose they go into insurance and they have senior securities outstanding. Suppose the wise policy is to stay off the securities for a year. Take the situation today, with the war. You have a constant demand to earn for your senior securities. What are you going to do? It hinders your investment policy.

Let me go on with a few more instances. As a lawyer you have drawn various trust indentures. You know the various provisions. Take the touch-off clauses. We have one group of witnesses who say you can protect senior securities if you put in touch-off clauses.

That means that securities will be sold out at a certain time if there are touch-off clauses. If they fall below a certain percentage of recovery, if you have \$1,000 of bonds outstanding and only \$1,500 to cover it, then the trustee must take action.

All of that requires a great deal of complicated legal rigmarole, and I think if you try to write an act which will give any protection or see that there is any protection for that security you will get an administrative act that will be a headache, and I personally do not think it is worth it where there is no economic justification.

I can give you people in the industry who will testify that touch-off clauses—and Mr. Bailie testified to that—is an instrument of the devil. He says it is a sword of Damocles over your head all the time.

Then we have instances where they have these touch-off clauses and they have evaded these protective provisions. No matter how well drawn they are, we have instance after instance where they evaded the so-called protective conditions. When the storms come and the winds blow the senior security does not turn out to be a senior security at all, but turns out to be in a tough spot.

Senator TAFT. I would rather differ with you, because you had extraordinary conditions in 1929. I think a preferred stock representing one-third of the value of the securities would be a safer proposition than the preferred stock in an industrial company of the same volume, because when an industrial company goes broke, it goes broke, whereas securities, if they are diversified enough, at least, ought not in the long run fall below a third of the value at which you buy them.

Mr. SCHENKER. Senator, we explored your idea of trying to see if we could not make provision for senior securities in the investment company. The fact of the matter is that in Great Britain they do have senior securities in the investment company, but, traditionally and historically, what do they do? They balance their portfolio so that the investments correspond to the outstanding senior securities. They have a certain amount of debentures, preferred and common stock. Their portfolio will have a comparable amount of debentures, preferred and common stock. That was to assure the debenture holder of the investment company that he is going to get an income which will meet his obligations.

The fact of the matter is that in this country, regardless of what the capital structure of the investment company has been, the average investment company, throughout its entire period, has been 80 or 90 percent of common stock. As a result you have this situation: Take an industrial corporation. They will not issue debentures unless they have an assured income, as in a utility or in a railroad, and even with the railroads they were disappointed after awhile. They won't do it unless there is an assured income with which they can meet the fixed charges of the debentures.

What is the basic asset of an investment company? It is common stocks upon which they may get dividends, or they may not get dividends, although in some respects, Senator, and I agree with you, a debenture in an investment company may have more desirable attributes than a debenture in an industrial corporation, because if an industry goes broke the debenture holders are left with bricks, boilers, and railroad tracks that they cannot make a nickel on. In an investment company you have marketable securities that you can realize on.

To my mind, you do not sell senior securities on the anticipation that you are going broke. If the company goes broke you can salvage a little.

I think you have got to look at the problem from the point of view that you expect the concern to be a going concern, and therefore we say that there should be one class of stock.

Now, we explored your idea, Senator, and what problem does it create for you? Of course, you said you would have a certain ratio of 30 percent in senior securities so that there would be adequate coverage in the first instance. Then would you make this provision in the senior securities? Let us take the case of a company in the event it was under water. Would you say they could issue one class of preferred stock or would you say, "Let them issue 1, 2, 3, or 4 of preferred stock?" Would you let them issue convertible preferred, convertible preferred 7 percent, convertible with optional warrants convertible not with optional warrants? Then would you say yes with respect to 30 percent of your issue that you can issue class A common, class B common, and so forth, debentures 54, debentures 64? You have that tremendous problem of trying to circumscribe and hedge the whole business. You would not countenance a situation such as we found, where the debenture holders put in \$5,000,000 and the common stock holders \$100,000 and that—

Senator TAFT (interposing). No; but I should think a provision of not more than one would be enough, without the rest of it. I do not feel strongly one way or the other. I do not see any reason for not having it. On the other hand, I do not see that it serves a good purpose.

Mr. SCHENKER. Our concept of an investment company is that it is a mutual enterprise. The stockholders being on a parity, there ought not to be any conflict between the securityholders of that type of institution. This ought to be a mutual enterprise, with one class, simple structure, no different than a bank, no different than an insurance company, no different than any other type of financial institution. They are all partners in a common venture. They all stand to gain or lose. There is no overreaching. There is no necessity for protection in situations where the common stock is under water, and the funds really belong to the common stock holders.

When you get into the debentures your problem becomes terrific. If you issue debentures, then, in my opinion, Senator, it may constitute a fraud, because when a person buys a debenture he thinks it is collateralized. He thinks it is secured.

Senator HUGHES. He thinks it is a sort of bond.

Mr. SCHENKER. He thinks it is a bond.

Senator TAFT. Well, it is a bond, is it not?

Mr. SCHENKER. It is a bond—

Senator TAFT. I mean, secured on marketable securities, presumably.

Mr. SCHENKER. That, Senator, is predicated on the assumption of either one of two things: Either that the assets of the investment company have been collateralized to secure debentures, which is never the fact; or you get what we call the touch-off clause, which requires the maintenance of a certain ratio between the assets and the outstanding debentures; or you take the other alternative where the debenture has no protective feature at all. In the last case you are

selling him an unsecured promissory note. He says, "I promise to pay you blank dollars at maturity."

The industry finds itself in this anomalous position. It says, "Let us issue debentures, but, for Heaven's sake, don't let us put any touch-up clause in it."

Why? Because it is a sword of Damocles over his head. His whole investment policy is not dictated from investment experience but from the exigencies of the situation that if he does not have some provision to make money fast his touch-off clause will be on him, there is a default, and the debenture holders will get the control of the company. So the unanimous opinion was, let us issue debentures, but do not require us to put any of these protective features in.

Under those circumstances we say, Senator, if you are going to sell to the average small buyer a debenture and then sell him an unsecured promissory note with such assets which fluctuate with such great variety, just make the provision that you will make him issue debentures to the extent of 33 $\frac{1}{4}$ percent of the company's assets. We feel that if you weigh it in balance, the thing to do is to cut the Gordian knot once and for all and say, "Let us make a simple structure, everybody on a parity, and a person would be able to ascertain what his value is, and everybody will have an equal participation in the selection of the management." You have to weigh the scales in those situations.

I am not saying that some preferred stocks of investment trusts are not good investments, but in all these situations you have got to take the advantages and you have got to take the disadvantages. From our study, and we have written a 500-page report on that, we are firmly convinced that the disadvantages inherent in senior and junior capital structure companies so far outweigh the advantages, that there is no question about it. Where you try to limit the number of different classes outstanding, try to legislate or regulate with respect to what protective features they should have, we say they should be like a mutual savings bank—one class of stock, no conflicts, everybody has a *pari passu* share in the voice of the management.

With respect to the companies in existence, Senator, we do not touch those. We say if you have preferred stock, that is perfectly all right.

Senator TAFT. What about (d)? Do you touch it in (d)?

Mr. SCHENKER. Which is (d), Senator? That is in connection with redistribution of voting rights. That is not going to hurt the senior security holders. The fact of the matter is that the whole purpose of that particular subsection is to give them some additional rights in those circumstances where he really owns the company and the fellow who has common stock not only has no asset value but may be 50 cents a share under water and is running the company without any participation in the senior security holdings. That subsection will not take away any rights from the preferred stock holder. The whole purpose of that is to give the stockholder additional rights.

Senator TAFT. How do you think that can be done constitutionally? I do not want to raise a constitutional question at this time, but how can that possibly be done?

Mr. SCHENKER. That is not an easy question, Senator, and we hope to be able to submit a memorandum on that, but the only point I am making at this time, Senator, is that I do not think you can

quarrel with the principle that an investment company which has fluctuating assets should not have senior securities in its structure. You might, with a great deal of effort and labor, try to model the preferred stock for that type of company and try to circumscribe and hedge it, but once you are trying to do that, necessarily they will say, "What logic is there in having one class of stock if I am going to limit my senior securities to 33⅓ percent of my assets"——

Senator TAFT. I think there is logic. I don't think we ever got in trouble with the other kinds of companies. It was when they began to branch out and these corporation laws permitted all kinds of securities that we got into trouble. It seems to me possible to allow one class of preferred stock, not to exceed one-third of the total, which is about as we had it in Ohio away back in the old law. I do not think we ever had any trouble with that. I agree with you. I do not like all these different——

Mr. SCHENKER (interposing). What happened was we have found every time you get the pyramid structure and pyramiding takes place, where you have more than one class of stock, there is no fun in paying a dollar to get control of the other fellow's assets. The only fun in getting control of it is where for a relatively small amount you can get control of the senior security holders' money, and in every case where there was a selling down the river there was a case of the common stock holder as selling the senior securities' money to somebody else.

What we are afraid of, Senator, is this, and I am not being critical, and I suppose you are going to hear a big defense of this. Take a look at the Tri-Continental set-up today. That is the type of capital structure that you may get into unless you take the most meticulous care in your statute to limit it to one class rather than try to limit it, in addition, to having a certain ratio to the outstanding securities. If I may be a little slangy about it, we do not think it is worth the fuss to try to make an elaborate provision, which will probably be page after page, to provide for a situation where a company may want at some subsequent time to issue a little preferred stock.

We say, considering the elimination of the conflict of interests, considering the other protection, considering the advantages that may flow from the additional capital structure provision, that for this type of business, just like for a bank and insurance company, it should be this way.

If the senior security holder has senior securities he may stay with them, but as far as the future is concerned, we think there should be one class stock company.

With respect to the going concerns, if they want to raise more capital, the only thing this provision does is to put more "cushion" behind the senior security. The senior security holder is the individual looking for safety. He says, "I am not interested in making a bunch of money. All I want is my principal back and a moderate return," and we say that is what he ought to get, and if these companies want to raise more capital, they can do it. All they have to do is to increase the common stock and they will increase the "cushion" behind the senior security holder.

We say, in addition, to protect the senior security holder who is investing in it for safety he ought to have something to say in the management of it, if he owns the whole company and the common