stock holder has no financial interest in the company at the time he is exercising control.

Senator TAFT. Do you say as to (d) you are going to submit a brief as to how it can be constitutional to require by your order that every company "take such steps as are necessary or appropriate to effect an equitable redistribution of voting rights and privileges"?

Mr. SCHENKER. We will prepare a memorandum on that.

Mr. SMITH. That is in the Holding Company Act already.

Mr. HEALY. I think a brief was prepared on that point when the Holding Company Act was passed by Congress.

Mr. SMITH. We have a number of instances of this where they had no control and no investment at all.

Senator TAFT. I think it is a real abuse, as far as that is concerned.

Mr. SMITH. There is just one other point that Mr. Schenker did not make, which always appeals to me. When a banker or broker lends money (and that is what happens when an investor buys preferred stock), it seems to me, he has a broad power of attorney signed. It gives him every power under the sun as to selling out, demanding more collateral, and he has a margin to protect himself, and you know how they sat up at nights when the market was going bad to demand more collateral. That senior security could be sold to an investor without the same protection that the trade demands, particularly in view of the improbable ability to even earn their keep or to be protected, even on the one-third basis seems to me unsound. Take that over a long period of time; you can't justify it on past experience. It may be different in the future.

I agree with Mr. Schenker that it is not worth the risk of it and all the dangers, particularly when it serves no economic function except possibly it helps to give something to people to sell, and we have had a lot of abuses from people taking advantage of emphasizing the safety and the senior nature. It is bound to be confused with a security of safety.

Mr. SCHENKER. May I make one other observation? Of course, I do not pretend to be an expert with respect to this matter. In some respects I may be a little naive, but it seems to me that this whole problem of senior securities in investment trusts is kind of academic. The fact of the matter is, as I recall, virtually all of the preferred stock are selling at a substantial discount. Why would anybody pay par for preferred stock of one company when he can go out and buy preferred stock of many companies at 70 cents on the dollar?

If we were convinced that we were impeding the raising of capital for this, that, or the other company, we would say, "Maybe it is worth while. We will stew around and give them a chance to sell preferred stock."

They could not sell preferred stock today, nohow, because you can buy substantial preferred stock at 30 percent discount. You can buy preferred stock of many companies at 70 cents on the dollar. Who is going to pay the full dollar on a new, untried venture?

Therefore, in many respects, for the immediate future the problem is academic, and so we say, let us make them simple and let us not get tricky—simple company, one class of stock, a mutual aspect, everybody sharing the risk, and everybody sharing in the profits pari passu, and everybody having an equal share in the profits of the company.

We attempted to fuss around and see if we could arrange some formula saying 33⅓ percent. We tried to make requirements similar to those of the Federal Reserve Board, which requires 50 percent. You always run into the problem, Well, is it going to be 1, 2, 3, 4, 5 class? Are you going to have any protective features? Are you going to have touch-offs?

For all those reasons we were compelled to recommend to the committee that there be in the future simple, one-class companies.

Mr. SMITH. In connection with the existing senior securities, there is one other provision in section 19 (b), where we attempt to give some protection to the existing companies and say that no dividends shall be paid on a preferred stock if there is not a 200 percent coverage of that preferred stock—that is, no dividends paid to the common stock underneath. In other words, to prevent taking away the assets under the existing senior security by the payment of dividends, we have a provision that is common. That type of protective provision is common.

There was one big investment company where the stock exchange said, "You can't pay any dividends on your preferred stock unless there is a 200 percent coverage."

I have a number of other examples where they used that type of protection, and the percentages vary—200 percent for preferred stock and 300 percent for debentures. It was a matter of judgment as to what point that was going to be.

Senator HUGHES. How are they going to get along with the fact that their charter may provide something else?

Mr. SMITH. The charter may permit them to do something——

Senator HUGHES. I am speaking of the past, one that is already in existence.

Mr. SMITH. This applies to them, and as to them we say that they cannot, even though the charters may permit them, pay dividends or make improper payments of dividends to junior and senior security holders. We say that whether their charter permits them to do it or not, if they have got less than $2 of coverage for every dollar they cannot pay dividends to a junior security holder. They can pay it on their own, but not on a junior.

Mr. SCHENKER. When I examined Mr. Odlum, in connection with the Atlas-Curtiss-Wright merger, I asked him if there was some reasonable ratio between the senior securities and the common stocks, and the other day he came to me and he said, "Maybe you are right, Dave," and that whole merger between Curtiss-Wright and the Atlas Corporation has for one of its motivating reasons the fact that Mr. Odlum wants to get the preferred stock out of the capital structure.

Take that type of company which does not invest in securities listed on exchanges primarily, but goes into the special situations. Mr. Odlum had $20,000,000 of his funds in the U. P. and L. and he was not receiving a return until it went through reorganization. That preferred stock was the darndest headache in the world to him. He could not meet the dividend payments. He says in that type of company, where you are going to perform an economic function and make capital available to small business, how are you going to assume to pay dividends on the preferred stock when you make your money not from a constant return but after the wind-up of the whole transaction and make it in one lump sum? So that the Atlas is deliberately getting rid of its preferred stock.

I know of another situation of a similar nature where that company is determined to get rid of its preferred stock. We have repeated examples and testimony where the people said that at the worst time in the market they had to liquidate their portfolios because they had to raise cash to meet the interest payment on the debentures. If they did not have debentures the history of their companies would have been different, they said.

You have all the complicated conflicting factors in the capital structures that have more than one class of securities, and I say if you weigh the scales and balance them as to the advantages and disadvantages, the balance is definitely in favor of one class of stock.

Mr. SMITH. Section 19 (*a*) deals with dividends.

Section 19 (*a*) (1) deals with payments of dividends from such other sources, and the first part of (*a*) (2) is a provision that, I believe, the New York Curb adopted a long time ago. It says if you pay out of anything but earnings you have to disclose it. Where these open-end companies pay out capital, and many of them do pay out distribution of capital, particularly in connection with the tax law and otherwise, we say you cannot pay out your capital and then not let the man reinvest it and charge him a sales load.

In other words, you cannot pay out the capital, and then he thinks, "Well, the company is doing very well and making money," and he puts it back again, and they take off 7 or 8 percent. You can keep going in a circle like that and gradually diminish the entire fund by taking 6 or 7 percent each time, as they do it.

I do not think there is any objection to that. As a matter of fact, one of the members of the industry suggested that this would be a very good measure.

Mr. HEALY. May I interrupt Mr. Smith long enough to say that this provision was recommended by a majority of the Commission? Principally, speaking for myself alone, I was raised in a jurisdiction——

Senator WAGNER (interposing). You are speaking of section 19 (*a*)?

Mr. HEALY. Yes, sir. I was raised in a jurisdiction where it is against the law to pay dividends out of capital. I think it is a perfectly sane and healthy rule.

It is very late, and as I have to make a quorum at the Commission, since we only have four members now and one is away, I do not want to get into a discussion of my views at this late hour.

Senator WAGNER. I think this is a good time to stop, anyway. It is getting near 5 o'clock. We are having a vote on the floor. We will resume tomorrow morning at 10:30.

(Thereupon at 4:55 p. m. an adjournment was taken until tomorrow, Wednesday, April 10, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

WEDNESDAY, APRIL 10, 1940

UNITED STATES SENATE,
SUBCOMMITTEE ON SECURITIES AND EXCHANGE
OF THE BANKING AND CURRENCY COMMITTEE,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, and Townsend.

Senator WAGNER. The subcommittee will resume its hearing. All right, Mr. Schenker.

Mr. SCHENKER. Mr. Chairman, Mr. Smith just has a few words to add to his statement of yesterday evening.

Senator WAGNER. All right.

Mr. SMITH. I just want to say a few more words——

Senator WAGNER (chairman of the subcommittee). I had been listening to Mr. Schenker and forgot that possibly you had not completed your statement. You may go ahead.

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

Mr. SMITH. I just want to say a few more words about this section 19 (a) of the bill; that is, in respect to dividends. We have provided in that section a moderate provision—that dividends can be paid out of capital provided they are allowable by charter and are segregated when paid.

Now, there are certain people who feel that dividends should not be paid out of capital at all or in no event if the capital is impaired. There is a good deal to be said for that point of view. I think Judge Healy would like to go into that in some detail when he has the opportunity. However, I think the rest of us feel that if you have a single-class structure—and there are other types of capital structures that must be covered, but I am referring more particularly to common-stock companies—if you have a one-class structure then the problems of dividends are much simpler. You do not have all the problems, as to whether it is fair to senior securities as to paying dividends in good times and slicing off the cream so that in bad times senior securities may be affected.

We have made this provision, which is comparable to the provisions of the New York Stock Exchange, to meet the situation, with the further provision that if they do pay dividends out of capital the investor shall have the right to reinvest this capital without a load. Thus they can pay out of capital but must let him put it back again without taking out 6 or 7 percent for load. This provision was was made to meet situations which may and do arise and was suggested by one of the larger trusts. The phraseology may not be complete to meet the situation, but the principle is certainly sound.

I might explain that——

Senator TOWNSEND (interposing). Do you intend to justify the paying of dividends out of capital at all?

Mr. SMITH. Can I?

Senator TOWNSEND. Yes.

Mr. SMITH. Sir, take a one-class company which has invested in equity stocks, we will say it raises $40,000,000 today. That $40,000,000 by reason of fluctuations in the stock market may go down to $15,000,000 and may go up to $60,000,000. It is a very volatile fund.

I think there are a great many investors who want to have dividends paid out of capital gains. We have taken the position that it is all right if they are expressly allowable. On the other hand, I think there are a great many people who will tell you that that has worked a fraud on the investor and that no matter how you make it allowable to make payments of dividends out of capital or capital gains, the investor will think it is earnings and be misled by it. There are certain investment companies who have used that practice in their selling campaign.

However, we have taken——

Senator WAGNER (interposing). Mr. Schenker cited a case where $800,000 was taken out of assets to pay dividends, and apparently it was done to make the stock attractive upon the market.

Mr. SMITH. That is right. And there was one company that promised a 5 percent dividend right along, forever and ever, whether earned or not. You will find that a great majority of these investment companies do in fact pay dividends out of capital even though the capital is impaired. Section 19 (a) is a provision that we have thought might cover the situation, but it would not bother me for you to make it more rigid.

One more point: In regard to existing senior securities we do have here still the problem of existing senior securities. Along that line we have adopted one provision—that if dividends are paid to junior stocks there shall be an adequate coverage, at least a minimum coverage, of assets for the senior securities. In other words, if there is $100 of preferred stock outstanding we have said: You cannot pay any dividends on the common stock unless there is $200 of assets to cover every share of preferred stock; otherwise you might be draining off the assets so far that when bad times came it would be unfair to senior securities.

Let us take the Tri-Continental Corporation charter. It says:

No dividend shall be declared upon the common stock unless at that time the net assets of declarant, as determined and computed in the manner provided in the agreement of consolidation, as amended, shall be at least 200 percent of the aggregate amount (exclusive of dividends accrued or in arrears) to which all shares of the preferred stock and all shares of stock on a parity therewith, then outstanding, shall be entitled as a preference over the common stock in the event of any voluntary or involuntary liquidation, dissolution, or winding up of declarant.