things—and you will see that it is not only in the case of equity securities that you cannot tell whether they are going up or down; for, Mr. Chairman, many so-called ‘legal’ securities have suffered enormous declines in value.

Many trustees of responsibility and character, especially those who have their own individual property subject to the hazards of litigation, are quite unwilling to be trustees if they are to be subject to suits, however groundless, by any beneficiary on alleged grounds of negligence. Especially when a trust with investments in common stocks is contemplated, a large number of Boston trustees take the position that the beneficiary, if he be an unknown member of the public, must make up his mind whether he is willing to rely on the character and proven ability of the trustees and whether he will forego the right to claim damage through negligence. If he does not care to have his property managed by trustees upon these conditions, then these particular trustees—and I include among them many of the ablest in Boston—say to the investor that he is perfectly at liberty to choose other trustees acting under different trust provisions or for some other investments.

We are not a high-powered trust trying to sell our shares to anybody.

If such protection must be omitted, then in my opinion the result in our section of the country will be inferior trustees or a very timid investment policy; that is what I think will happen. It is perfectly simple and easy for investors to buy Government bonds or Liberty bonds, and nobody will sue them; but if we are perfectly willing to take chances—as you must, in an equity security—then I think the present form is proper.

I repeat that no trustees, at least of the old school, would ever have made the reputation enjoyed by many, at least in Boston, had they been anything but the most careful of men; but the difference between being actually prudent and careful, and being adjudged prudent and careful by a tribunal after expensive litigation, is very great as a practical matter. That is the problem with which they are faced.

Turning from history for a moment to the provisions of the proposed legislation, let me point out what the bill as drafted would do to the Boston Personal Property Trust.

In the first place, through the expense of counsel fees, stockholders' meetings, registration, additional accounting service and reports, surety company bonds, and so forth, I estimate that the beneficiaries would be subject to an additional expense equal to at least a 50 percent increase in the normal Federal tax on their income. The Boston Personal Property Trust operates, I believe, at a lower annual cost to its beneficiaries per dollar of income than any other trust in the United States. I may be wrong; I am not sure that is so; but, at least, the cost is one of the lowest. After talking that over with Mr. Kelley Anderson, I believe there is a fraction of a hundredth of a percent that may vary; and if his cost is lower than ours, I take off my hat to him.

Mr. Griswold. And our costs are lower.

Mr. Bundy. Are your costs lower than ours, too? Well, I take off my hat to you, too. The trustees' fees are limited to 5 percent of the income. The trustees do not receive as much as 5 percent, for 40
percent of this 5 percent is paid for the services of the State Street Trust Co., which is custodian and agent in handling the general details of the operations of the trust. I note that a number of witnesses from the investment company industry have testified that they favor some regulation. Perhaps I am more than ordinarily blind to the necessity of regulation. I may be blind. In the case of the large trusts, regulation may not mean a large expense per share; in their case I do not think that regulation necessarily will cost them a great deal per share. However, in the case of the Boston Personal Property Trust, we are a small trust, and I figure that in our case Federal regulation in any such form as that now proposed will mean a very heavy burden on each of our shareholders.

Second, the provision of the proposed bill which prohibits a trust from having in its portfolio any securities of a company in which one of its trustees is a director, unless the trust holds at least 5 percent of the stock of that company, would require us to eliminate all but one of our trustees, or to change entirely our portfolio of investments. The Boston Personal Property Trust has always turned for its trustees to men of experience and standing in the community. Such men are generally directors of companies whose shares would be natural investments for the trust. You have already heard the testimony of Mr. Charles Francis Adams, our senior trustee. We hold the securities of a number of companies of which Mr. Adams is a director. We hold shares in other companies of which one or the other trustee is a director. Never in my experience of 11 years as trustee have I seen an occasion where there appeared to be the slightest conflict of interest in any matter involving the Boston Personal Property Trust and any company or the investment in any company of which one of our trustees happened to be a director—except, perhaps, one case; and in that instance we just did not happen to buy those securities for our portfolio; and in those 11 years I have not seen a single occasion where I could see or imagine or suspect a condition where our trustees were affected in their judgment by the fact that they were directors in the companies whose securities were held in our portfolio.

Third, the proposed investment trust bill would require a complete revision of our trust instrument, and would force every minority shareholder to be in the hands of the vote of a majority of the shares as to who should be the trustees, no matter whether he personally preferred and invested his money upon the agreement that the present trustees would select their own successors. As to the wisdom of such a change, I have already commented.

Fourth, the trust would also have to be revised to eliminate all provisions protecting the trustees against litigation of the kind I have outlined; and, more than this, the bill would require that no complaint of the usual nature against trustees, alleging breach of duty to shareholders, could be settled without actual suit being brought and, after suit, without the consent of the S. E. C. A groundless $50 complaint by a totally unreasonable shareholder might involve the trust and the trustees in hundreds, or even thousands, of dollars of expense, including trips to Washington, and all the incidental difficulties and machinery of dealing with the governmental body—the S. E. C.—which in my judgment is already somewhat overburdened with other duties.
I have not tried to go into the vast number of provisions of this very long bill; but I am convinced that if the bill is passed, there would be very serious question whether the Boston Personal Property Trust, which for 47 years has served its shareholders well, would not be liquidated. I do not know whether it is of the slightest importance to the country at large whether we are liquidated or not; and it is not of much importance to the trustees. I just do not know whether our trustees would be willing to do that; I doubt whether our trustees would be willing to continue with a restricted portfolio and different personal obligations, and I doubt whether the beneficiaries would be prepared to continue with the additional expense involved.

If it is important for national reasons to control large investment trusts, because of their size and power, or if it is important to provide a medium for the investment of money in investment companies closely regulated by the Federal Government, I suggest for the committee's consideration the possibility of having two groups of investment companies in the United States—regulated companies and unregulated companies—and definitely announcing to the public that an investor who puts his money in an unregulated company does so with knowledge that he is not protected by the S. E. C. or by any Governmental regulation and that he takes his chance with only the protection afforded by the common law and the special provisions of the trust instrument, if he is willing to trust the management of any company which is not regulated.

I suggest that it also be left to the decision of the shareholders of companies as small as we are whether they prefer to have their company regulated and supervised or whether they prefer to go on as they now are, with the full understanding that regulation means expense and that regulation means the kind of protection which the S. E. C. desires to give to the investors.

With such an alternative I should be quite willing that our shareholders should make their own decision; and I suggest that it is going a long distance—and I submit a long distance down the wrong road—to so legislate that if, after full disclosure, an investor in Massachusetts prefers to rely on the character and ability of trustees operating under the old, historical form of Massachusetts trust, rather than to invest in some new streamlined vehicle regulated by the S. E. C., he should not have the liberty to choose the older form.

Senator Hughes. May I ask you a question: How many do you suppose would choose one and not the other?

Mr. Bundy. I do not know, in general; but I think I have a shrewd guess as to what our shareholders would do.

Senator Hughes. The fact that a company was regulated probably—to the average investor—would make him feel that he was safeguarded to that extent—and probably to the detriment of one that was not regulated?

Mr. Bundy. That is perfectly all right with me, Mr. Chairman. If they prefer it that way, that is all right with me.

Senator Hughes. You are speaking for your own company?

Mr. Bundy. I am speaking for my own company, and not in general.

I suspect that there would be media of investment, of our character, in which people would prefer to invest because of the character involved and because of the continuity of management.
If you have a large open-end trust, operating all over the United States, with salesmen in every district, I think you probably would find that they would come under that regulation.

Thank you.

Senator Hughes (presiding). Thank you.

Mr. Orr.

STATEMENT OF JAMES H. ORR, PRESIDENT, RAILWAY AND LIGHT SECURITIES CO., BOSTON, MASS.

Senator Hughes. Mr. Orr, will you please proceed?

Mr. Orr. Thank you, sir.

Mr. Chairman and Senators, my name is James H. Orr. I am president of the Railway & Light Securities Co.

You have just heard from Mr. Bundy, who is the representative of the oldest investment trust in the country. I think I can say that the Railway & Light Securities Co. is the oldest investment trust company with senior securities outstanding.

I wish to confine my remarks in reference to the proposed Investment Company Act to three phases of its effect on the Railway & Light Securities Co. and its stockholders and on other comparatively small investment companies in a similar position. The points which I should like to discuss briefly are the following: first, restrictions pertaining to senior securities, both debt and preferred stock; second, increased expenses resulting from operations under the numerous regulations specifically set forth or contemplated under the broad delegations of regulatory authority; and, third, the unwarranted management prohibitions resulting from the provisions relating to conflicts of interest.

In so limiting my comments, however, I do not endorse the balance of the act which I think is, as a whole, cumbersome, complicated, and largely unnecessary.

Before discussing the three points which I shall concentrate on, I should like you to have in mind the general set-up and history of Railway & Light Securities Co.

Railway & Light Securities Co. was organized in 1904 with a capital structure consisting of bonds, preferred stock, and common stock. This form of capitalization has continued to date. At present, there are outstanding $4,000,000 in face amount of 4½-percent collateral trust bonds, $2,113,600 par value of 6-percent preferred stock, and $3,327,000 of common stock, the latter figure being computed at asset value. Senior securities, therefore, represent two-thirds of its total capitalization. Interest charges and preferred dividends have been paid without delay since organization, a period of 35 years; and, in addition, a dividend has been paid on the common stock in 27 of the last 30 years. Until 1928, the purpose of the company as set forth in the charter was the holding, for income and for sale, of securities of railways and other public utilities; but in 1928, with the express approval of the stockholders, the company was reincorporated under the laws of the State of Delaware, and the purpose was broadened so that securities of all classes of corporations could be purchased. Six of the nine directors can be classified as investment bankers or affiliates of investment bankers—not all from the same investment-banking house, however. For the most part, these investment bankers have been engaged in the investment banking business.
bankers or their firms have been interested in the company since its inception. Subject to the supervision of the directors, an investment manager or investment adviser, as defined in the proposed act, furnishes services to the company; and approximately one-half of the stock of this investment manager or adviser is owned by the Railway & Light Securities Co.

Now fit this statement of facts into the three phases of the bill on which I want to comment, and which are the points which I think affect us very seriously. By so limiting them, I do not mean to endorse the balance of the bill, which I think is cumbersome, complicated, and largely unnecessary. You have already heard comments regarding these other points, from Mr. Myers, this morning.

As I say, the three points to which I shall confine my comments relate to restrictions pertaining to senior securities, both debt and preferred stock; increased expenses resulting from operations under the numerous regulations specifically set forth or contemplated under the broad delegations of regulatory authority; and, last of all, the unwarranted management prohibitions resulting from the provisions relating to conflicts of interest.

Following those in order, first let me consider the restrictions pertaining to senior securities. Our problem on this is not in the future; it is right now.

We have made up a chart showing what the effect of our operations would be, as governed by these proposed provisions, or showing the effect of this provision on our operations since 1906.

You will recall that the bill provides that you cannot pay dividends unless you have an asset coverage of 300 percent—and, incidentally, let me offer this chart for the record at this point.

(The chart entitled “Railway and Light Securities Company, Per Cent Asset Coverage per Outstanding Bond at Par for Determining Dividend Payments Under Investment Company Act of 1940,” appears on the opposite page.)

Mr. Orr. In the middle of the shaded zone on the chart is a heavy line which shows 300 percent. Fluctuating around that is the computed asset coverage, as computed in the method prescribed in section 19 of the bill. If you look at that chart, you will see three zones: a “free zone,” where you went over 400 percent—and where the S. E. C. can raise the 400 percent statute limitation, too.

Then you see a shaded zone which is a 200- to 400-percent zone, over which the S. E. C. has jurisdiction.

Below that is a zone where we have gone below 200 percent; and the bill provides that when we are operating in such a zone we can pay no dividends.

At the present time we are operating at about 240 percent, so we are below the 300 percent mark, and we cannot pay dividends on either preferred or common stock unless the Securities and Exchange Commission tell us that we may.

As a matter of fact, in 28 out of the last 34 years, when we paid preferred dividends, we would not have been able to pay them—according to the provisions of this bill—without the approval of the S. E. C.

This, to my mind, does rather grave violence to dividends and to the contractual rights with respect to dividends, as between the various classes of security holders.
RAILWAY AND LIGHT SECURITIES COMPANY
PER CENT ASSET COVERAGE PER OUTSTANDING BOND AT PAR
FOR
DETERMINING DIVIDEND PAYMENTS UNDER INVESTMENT COMPANY ACT OF 1940
AS PROPOSED BY THE S.E.C.
BASED ON BOOK VALUES 1905-14 AND ON MARKET VALUES 1915-40

FREE ZONE
S. E. C. ZONE
PROHIBITED ZONE

INVESTMENT TRUSTS AND INVESTMENT COMPANIES
To recapitulate, we see that section 19, dealing with dividends, makes it unlawful to declare or pay a dividend on any junior securities unless first, the asset coverage of debt equals 300 percent and/or second, the asset coverage for preferred stock equals 200 percent. However, the Commission, by rules and regulations or order, may vary these limits, in the first place, for debt, between 200 and 400 percent asset coverage or, second, for preferred stock, between 150 and 300 percent asset coverage. As contrasted with the foregoing dictated asset coverage, the Railway & Light Securities Co. now has asset coverage of 238 percent for its bonds; so that without obtaining favorable action on the part of the Securities and Exchange Commission, we would be unable to pay either preferred or common dividends. Accordingly, management judgment on dividends and the contractual rights as to dividends between the various classes of security holders represented by the Delaware laws and the company's charter, issued pursuant thereto, are completely set aside.

In order to portray how completely this is done, I have—as I said—prepared a chart showing our bond asset coverage back to 1906; and from this you will observe that in 28 out of the last 34 years, the bond asset coverage has been below the dictated 300 percent. The shaded area shows the range of 200 to 400 percent asset coverage in which the Commission has jurisdiction. At some time during 31 out of the last 34 years, our asset coverage was within this range. In 6 years the debt asset coverage went below the minimum of 200 percent established in the bill; and in such years dividends would have been deferred.

The restrictions I have just referred to apply to both preferred dividends and common dividends; but, in addition, our common dividends would be subject to a required asset coverage for the preferred stock. In the interests of brevity, I am not going into this except to state that we would have been even more restricted with respect to common dividends. Nevertheless, as previously stated, on a nonregulated basis we have paid dividends regularly on the preferred stock and, regularly since 1910—with the exception of 3 years—on the common stock. As far as I know, no bondholder or stockholder has had cause to complain of any injury due to the payment of these dividends.

Mr. Chairman, we have taken a rather lenient view regarding that provision of the bill. The bill provides that we shall figure what the ratio of our assets may be to the total liquidation preferences.

In our company we have two liquidation preferences contemplated by the Delaware laws. One of those liquidation preferences is a voluntary one, and the other one is an involuntary one.

In the case of the involuntary one, that is the one we have worked out here; but if we had used the other one, there would have been a great many more years when we would have been unable to pay dividends; because you see the preferred stock has a call price of 125 for a certain kind of liquidation; and with $2,125,000 of that preferred, there is half a million dollars more coverage which would have to be multiplied by the 200 percent provided in the bill.

Furthermore, a shrinkage of 15 percent in the value of our assets would automatically stop dividends, both preferred and common; no matter how temporary the shrink, the continuity of dividends would thereby be impaired. As the asset value approached these
arbitrary "flash" points, a dividend payment date would present a very interesting problem in market forecasting. The act says that these asset coverages must exist immediately after the payment of the dividend. The declaration of the dividend and the payment thereof cannot possibly take place on the same day; an interval of several days must elapse in order to allow time for the mechanics of payment. A market collapse within this interval could make invalid a dividend properly declared a few days before.

In connection with this dividend question, I should like to point out to you that over the past 25 years, the average rate of return on the invested assets of Railway & Light Securities Co. has exceeded the cost of the senior money, including as part of such cost an allocation of our operating expenses and taxes. This is contrary to figures submitted to you earlier in this hearing indicating that the average rate of return on invested assets would be between 4½ and 5 percent, which would be less than the cost of the senior money irrespective of expenses and taxes.

Now bearing in mind that the proposed act is allegedly designed to be in the interests of investors, what proportion of investors in securities of investment companies are not benefited by such provisions, but on the contrary are injured by having their rights to receive income seriously impaired, and, therefore, the market value of their holdings. Certainly, it would be a new investment concept that it is an advantage to an investor to have additional uncertainties and conditions imposed on his rights to receive income.

The Commission's report shows that at the close of 1936, the common stocks of 102 "management investment companies proper" and "management investment holding companies" which had senior securities outstanding ahead of them, had an equity value of $1,243,000,000. In addition these companies had outstanding $239,000,000 of preferred stock preceded by debt. The total of these holdings of common and preferred stocks aggregated $1,482,000,000 and all of them will be adversely affected by these uncertainties as to future dividends; this figure represents 40 percent of the $3,673,000,000 total assets of all management investment companies that were classified in this report.

Furthermore, these restrictions operate without taking into consideration the character of the assets of the company, which can range from Government bonds to the thinnest of thin equities. In the case of Railway & Light Securities Co., it has been our general practice to hold bonds in the portfolio in an amount approximately equivalent to the face amount of our own debt outstanding. We do not in any way recommend this as a restriction which should be pressed generally on the industry, but it is a very important factor in determining, in the language of the bill, the speculative character of the junior securities of Railway & Light Securities Co. This is a recognized theory in banks and financial institutions and should apply equally well in the case of investment companies. I quote from the Monthly Review of the Federal Reserve Bank of New York for April 1, 1940 [reading]:

From one viewpoint, perhaps the most significant capital ratio is the percentage of capital funds to the total of all bank assets in which there may be shrinkage in value under adverse conditions. Such protection (afforded bank depositors by bank capital) depends upon several other factors, including the proportion of cash held by banks against their deposits, the proportion of bank funds invested in assets subject to potential shrink in value and the character of such assets.
As a matter of fact, the dividend provisions of the bill might result in forcing liquidation of this company in whole or in part. As previously pointed out, dividends on the preferred stock will be largely contingent on fluctuations in the market value of our assets and the Commission's discretion. This certainly does sufficient violence to the rights of the preferred stock, so that a holder should be offered some alternative. The only alternative which the company could proffer would be liquidation. But before we could do that we apparently have to come back to Washington and take up the matter with the Commission all over again to be sure we are not violating section 23(b), which prevents retirement of securities in contravention of rules or orders of the Commission. This section 23(b) again subordinates management control and judgment to the will of the Commission and this time in the important field of refinancing.

The foregoing applies to senior securities now outstanding and does not apply to new issues, because under section 18 of the act no such securities could be issued.

Now consider this section 18. Take first the simple case of a reorganization or consolidation of two companies with senior securities outstanding and, in my opinion, if the act is passed, there will have to be many such consolidations, due to the necessity of greater size in order to bear the burden of increased expenses incident to operation under the act. It is conceivable that in all such reorganizations or consolidations the equities and interests of all security holders, both senior and junior, can be effectively represented in a new issue of only common stock? My experiences and observations have been decidedly to the contrary. Perhaps some new capital may be required to effect the reorganization or consolidation; if the new capital cannot be raised via common stock, the proposed act is an effective bar to the whole program. Instead of helping the small investor, this may well result in freezing him out of any possible chance at a recovery from a period of depression. Even the Public Utility Holding Company Act, which limits the types of financing which a utility holding company may effect, recognizes the peculiar characteristics of mergers, consolidations, reorganizations, and other special situations by removing the ordinary limitations in such cases.

You have been told that banks are permitted to have only one class of capital stock. I would call your attention to the fact that since 1933, national banks have been permitted to issue capital notes and/or preferred stock and many of them have taken advantage of this permission. Was it against the interest of investors in bank stocks to have the Reconstruction Finance Corporation purchase over a billion dollars of preferred stocks of such banks? On a strictly comparable basis, bank stocks were already margined over 6 to 1, and it is now over 8 to 1, because their deposits, which are payable on demand, are just as much a debt as a bond, payable at a future maturity date.

My difficulties with the senior capital restrictions go further, however, than just the effect on existing capital structures and on reorganizations and consolidations. The bill proposes not only to eliminate abuses, but also to dictate economic behavior by investment companies and by the public which buys securities of such companies. You will recall that comment has been made earlier in the testimony before your committee of the merits of investment companies for the diversification of risk for the small investor. But suppose the small investor