investment, over a period, of $10 a month instead of $1,000, and the average is $500, the load is much higher.

Senator Taft. Do you know the limit on that in Ohio? As I understand we have in Ohio an express limit on loads in investment trusts.

Mr. Smith. I am not familiar with Ohio. I know that in a number of States it is 10 percent.

Senator Taft. Did you say 10 percent?

Mr. Smith. Yes.

Senator Townsend. In your experience what would be a reasonable amount for the load?

Mr. Smith. From my experience I would like to see investment company securities sold at a load of 4 or 5 percent. However, I think there are difficulties in fixing a flat amount because that might become the maximum. That is what I am afraid of.

Senator Townsend. Do you mean that you would like to see them sold on the basis of 4 or 5 percent, and in this case it is 6 percent?

Mr. Smith. Yes. But we do not attempt to regulate the load unless it is excessive.

Senator Taft. If a new investment company goes out and sells securities, not just stock-exchange securities but securities connected we will say with some venture, is it 15 percent? It seems to me we have a 15-percent limit in Ohio on promotions.

Mr. Smith. Will you pardon me for a moment and let me ask someone here?

Senator Taft. Certainly.

Mr. Goldsmith. Well, in recent years, according to registration statistics, bonds and preferred stock were predominant. The rates were very low. But I take it you are talking about common stocks only.

Senator Taft. Yes.

Mr. Goldsmith. In recent years there have been practically no sales of common stock issues of a size comparable to many of the investment company issues. I think it is hard to make a comparison. For small issues of stock, of course, the total selling cost is very high, and as you say it may be 10 percent or 15 percent or perhaps even 20 percent.

Senator Taft. My impression under the "blue sky" law in Ohio is that it is 15 percent, that that is allowable. That does not mean it ought to be that amount, but I think that is the load.

Mr. Smith. I think there are a number of States that have 10 percent on investment securities.

Senator Wagner. We have here a table, have we not, of the load the different companies charge?

Mr. Smith. That is correct.

Senator Wagner. I referred to that on yesterday when I asked a question of Mr. White, who represented a very well-run investment trust. They charge no load at all, but that is an exceptional case. I asked him whether 7 or 8 percent would be a reasonable charge and he said "That is getting way up in the higher brackets." He is known as a successful operator.

Mr. Smith. Certainly investment counsel who do not actually solicit sales are able to have a very low load. They are primarily interested in the management end of the business.
Senator Wagner. The reason they do not charge a load is because they are not selling to the public at all, but have their own clients.

Mr. Smith. Yes; and if one sells to the public it is more.

Senator Wagner. I do not mean that one should not charge a load, but I think the evidence you have presented here showed an average of 7 percent, and that some went as high as 20 percent.

Mr. Schenker. As high as 17.65 percent.

Senator Wagner. Certainly that is high enough.

Senator Townsend. Mr. Smith, this average you showed here gives about 6 percent, does it?

Mr. Smith. That is right. Those are over-all figures and I think they included some that were higher and some that were lower.

Senator Townsend. Yes, but the average is about 6 percent.

Mr. Smith. Yes, sir.

Senator Wagner (chairman of the subcommittee). You may go ahead, Mr. Smith.

Mr. Smith. Just one other fact that will indicate the wide scope of the problems in this industry: Total repurchases of closed-end companies amounted to $533,737,000. These were made at aggregate discounts below asset values of well over $100,000,000. The losses to investors who sold their securities (on the basis of the difference between the repurchase prices and original offering prices) amounted to about $300,000,000. These losses on the basis of discounts below asset values were, of course, a gain to the remaining securityholders.

I think it is fair to say that in this huge volume of repurchases by investment companies of their own securities, there are relatively few cases in which there is not involved the fairness of the prices paid, either because one is buying a senior security at a big discount or because of its effect upon the common stock.

Senator Taft. How do you account for the fact that closed-end company securities are sold below asset value? Is that a tax question primarily?

Mr. Smith. I think it is partly a tax question, but I think a substantial part of it is caused by the tax discrimination against closed-end companies as opposed to open-end companies, in which the----

Senator Taft (interposing). A part of this $300,000,000 loss is caused by the Government’s tax policy, is it?

Mr. Smith. Do you mean in the case of repurchases?

Senator Taft. Yes.

Mr. Smith. Well, I think this is so; that the Government’s tax policy only went into effect in 1936, and these repurchases I think all took place prior to 1936. So that as far as that is concerned it would not affect these figures. As far as discounts today are concerned I think the Government’s tax policy undoubtedly has an effect upon selling at a discount. A great many people have also testified that there is doubt whether the management can justify itself and the costs of operation.

Senator Wagner. Is there discrimination as between closed-end and open-end investment trusts in the matter of imposition of the tax?
Mr. SCHENKER. On that, Mr. Chairman, the present state of the law is that open-end companies have a tax exemption under 48 (e): Closed-end companies do not have the same tax treatment.

I might say that we have been in close contact with that proposition, and have discussed it with the representatives of the closed-end companies and others.

Senator TOWNSEND (interposing). Can you state why that is?

Mr. SCHENKER. Yes; I think I can state my difficulties with the tax exemption for open-end investment companies. Unfortunately there is no legislative history upon that provision in the tax law. As I remember it that was introduced on the floor and the first thing I knew about it was that the open-end companies as contra-distin-
guished from the closed-end companies, gained that tax exemption.

Senator WAGNER. What year was that?

Mr. SCHENKER. It was in 1936.

Senator TOWNSEND. Is it in the law or in a ruling?

Mr. SCHENKER. It is in the law. The tax exemption obtains if they distribute their income and capital gains—then they are not subject—I mean the corporation is not subject—to a tax on capital gains, but its shares are only subject to the single tax in the hands of share-
holders. So that eliminates the double taxation.

There are two theories, or one major theory at least, advanced for that tax exemption. I think it was the President who said in some address that he could visualize if you had a simple company which was made available to small investors, a mutual company, then it might be entitled to some tax exemption.

Now, the so-called mutual company, or open-end company, was designated as the type of company which would be entitled to the tax exemption, although in my opinion the only difference between an open-end company and a closed-end company is the shareholder's right to redeem.

Now, to our minds—and we have expressed it before the Senate Finance Committee—that there is no reason for discriminating between investment companies merely on the basis of redemption features. Securities of closed-end companies today are selling at a discount, which in my opinion to some extent reflects the tax situation. Mr. Bunker thinks we are responsible for it in a little measure with our investigation, but I think I am not being impertinent when I say I think it is due to the fact that the public have no confidence in the investment trust situation unless it is regulated.

After all the discount represents what? It represents the public's appraisal of management, the public's appraisal of what they think of the investment-trust institution. Because, what are they saying—

Senator TAFT (interposing). Do you not think it is fair to say it is due, more than any of the reasons you have given, to the public feeling that stocks are not going to go up, that they are more likely to go down? [Laughter.]

Mr. SCHENKER. It may very well be that is so, Senator Taft.

Senator TAFT. And that they cannot get their money out, or if not that, what is it?
Mr. SCHENKER. What it means in simple terms is, that the public at the present time feels that a dollar in the hands of investment trust management is only worth 70 cents.

Their securities are selling at about a 25 to 30 percent discount. What that is attributable to I do not know; whether it is because of lack of confidence in management, in its expertness, or in the stock market, or because of the tax situation, I do not know.

Section 48 (c) has certain limitations. There is the limitation that you cannot have more than 5 percent in one company and cannot own more than 10 percent of the outstanding securities of one company. It has also the provision that your portfolio turnover cannot be more than a certain percentage. That is expressed in terms of gains on securities, held less than 6 months. It has also a provision about debt: If you have debt outstanding more than 10 percent of your assets the company is not entitled to the tax exemption.

The fact of the matter is that there are closed-end companies which can comply with all of these provisions, except that a stockholder should have the right of redemption. To our minds that is not a basis for discrimination between the companies, because as we will show a little later on, this open-end feature (as was stated by Mr. Leffler who started that type of company), is not an unmixed blessing.

With the open-end company you have a situation where you have to continue to sell your securities. You have all of the problems of distribution, sales load, and dilution. To our minds the test should be mutuality, as the name expresses, with supervision by some governmental agency.

What is the situation today? Regardless of what the load is, and you can charge a 40-percent load, you would still be entitled to the tax exemption. Regardless of the management fees in the companies if you want to take a 100-percent profit—you still have the tax exemption. Regardless of what it costs to run the company you still have the tax exemption. Regardless of whether the stockholders have the right to vote or not, or to get rid of the management, you are to the tax exemption.

To us mutuality connotes mutuality. It is the same concept you would have in the case of a mutual savings bank. It is a mutual enterprise in that the management is subject to the votes of all the stockholders. We say the test should be not in redemption or no redemption, but whether it is a mutual company supervised by a governmental agency.

We feel, and the Commission has so told the industry, that if closed-end companies are supervised by a governmental agency, and you have that diversity feature, with one class of stock, and with the same right of vote in all stockholders, there is absolutely no reason for that discrimination. That is our approach to the tax problem.

May I say this: In giving this figure of an aggregate loss due to mismanagement of $1,100,000,000, I would like to indicate one or two things.

Mr. Bunker said he was talking about the "sample" and I was talking about "the specimen.” Well, I say candidly, and I am not trying to impugn the whole industry—on the basis of this 4-year study—I was talking about the sample and he was talking about the specimen.

Mr. Bunker discussed his own company—and when you are talking about the Lehman Corporation you must remember that you are
talking about the creme de la creme of the investment trust industry. [Laughter.]

When you talk about performance in the investment trust industry—and he was discussing 49 hand-picked companies—companies which we picked as the largest companies which had only one management throughout their existence. We took the best companies, the best and largest companies, and we said: Let us see what management can do? We did not include all the companies that went broke. We did not include all the companies with mismanagement. We did not include them, because we said: Let us take the best companies and see what they can do with the management of other people's money.

Now, of this $1,100,000,000—and we will make the names of the companies available to the subcommittee if you wish—I think it might be unfortunate if the Securities and Exchange Commission were to say here there was mismanagement in this or that company, because you might get strike suits. But I will give their names to the subcommittee if you wish.

What did we do when we computed this $1,100,000,000 figure? United Founders had $500,000,000 and went down to $40,000,000. We did not include that $500,000,000 as due to mismanagement. We only picked out those situations where securities were unloaded on the company, where the management was acting with an ulterior motive. In regard to Founders we said approximately $300,000,000 of that shrinkage was due to mismanagement—if they mismanaged $300,000,000 it was probably the proximate cause for the loss to the rest of the funds, but this remainder was not included.

Now, in connection with the Eastern Utilities Investing Corporation, which went into the wringer, we did not include all the money that was put in. We tried to appraise these situations where there was mismanagement.

Take Mr. Smith's case of the loans to the bank officers. They loaned money to officers and directors, who got into margined accounts and gambled their heads off with investment-company funds and bank funds. We do not say all that money lost in those companies was due to mismanagement. We only took the loans to officers and directors. That is what I think Mr. Smith means.

Mr. SMITH. Yes.

Senator WAGNER. What company was that?

Mr. SCHENKER. The Liberty Share Corporation, up in Buffalo. I wanted to indicate the constituency of the figure 1,100,000,000.

Now, coming to this concept of performance: I say we were talking about the sample and he was talking about the specimen. I am prepared and would like to discuss—well, let us take the Lehman Corporation, which is as Mr. Bunker says, is the first or second best performing trust in this country.

I would like just to indicate this if I may, and I think I am right, and if not, Mr. Bunker will correct me. We have a wonderful instance in the case of the Lehman Corporation. I think they made their offering on September 25, 1929, and they got their money when the market commenced cracking, and were therefore in a fortunate position. When the real crack came they had cash; so that the statement made that they passed through the greatest cataclysm so far as October of 1929 is concerned, does not affect the Lehman Corporation. But I think that is a minor point.
Mr. Bunker, in his prepared statement on page 12, said:

Now this business of selecting specimens may be interesting but it is not very instructive. For example, if it fell to my lot to argue the other side of the case, I would produce specimens having as much virtue as the ones you have listened to had vice. To illustrate, it was necessary 3 years ago for my company to report on the state of its affairs before the Securities and Exchange Commission. I cite this particular example because the Securities and Exchange Commission is officially in possession of the same data.

I will read this carefully. I want to get it clearly before you:

It was able to state that for those stockholders who had paid $104 on the date of formation of the company, namely September 25, 1929, there were available for each share of stock on November 7, 1936, assets of a net value of $134.34; and that, further, in the meantime each share had received during that period of 7 years $19.35 in dividends.

Now, of course the thing that struck me immediately was this date, November 7, 1936, a date which looked like an odd date. But Mr. Bunker tells me that is the date he testified about.

I have here the report of the Lehman Corporation which sets forth a comparative table giving asset values of the Lehman Corporation for each year. Now, November 7, 1936, I am pretty sure was the peak of performance of the Lehman Corporation. If you take June 30, 1935—and we took in our questionnaire the cut-off date as of December 31, 1935—the Lehman Corporation had $31.33, and there was a 3 to 1 split-up. That means that they had $93 or $94 a share—and I am coming to the dividends in a moment. If you bring it down to date you would not have $134 for each share. What you have is $32.53, and if you multiply that by 3 you have $97 a share.

In the interim they paid an aggregate of $40 a share in dividends. That means they had $137 for the period.

Now, I am not going to make comparisons because as I will show in a moment nobody is more conscious than we are of the difficulties of management. The fact of the matter is that throughout this investigation we were insisting that managing other people's money was a tough job, and we were insisting that unless you had the necessary precautions to stop looting and mismanagement, the industry as a whole would not serve a useful function.

You can make a comparison of this performance with Government bonds, in which event he would have $137 today. If he had it in a mutual savings bank he would have $137 today. And yet you must consider that this value of the Lehman stock today was only after—and Mr. Bunker will correct me on this if I am wrong—$1,800,000 was paid to Lehman Bros. for management fees, and Lehman Bros. got in addition about $1,500,000 to $2,000,000 in brokerage and about $3,500,000 to $5,000,000 was spent by Lehman Corporation for research in addition.

I am just pointing that out to show how difficult the task is of managing other people's money even when you try to do the job, and the danger there can be to the public if you let everybody else run around loose and unload securities and all that.

On thing further: I would like to analyze the $97 a share they have left today and see what the situation is. If you will bear with me one moment I would like for the Senators to take a look at page 10 of this report. This report will give you some indication of the conduct of this investigation. On the basis of the questionnaire material, we prepared a report on each company.
Senator Taft. Is this the same thing that I now have before me?

Mr. Schenker. Yes, sir. We all have the same data. We prepared this report and then called them down here to Washington, and let them read it, discussed it with them, and let them criticize it.

On page 10 of the report what do we find?

Senator Townsend. What is the procedure of a corporation purchasing its own stock?

Mr. Schenker. They just go out on the market and buy it. That is a very important problem, one that is entitled to a great deal of consideration, and I will discuss it in a moment.

They made the statement unequivocally—and I do not know why—that for every share of stock sold for $104 in 1929 they had $134 a share.

Now, if you will take a look at page 10 of that report you will see that the Lehman Corporation repurchased, within a period of little more than 2 years, 33 1/3 percent of its total outstanding stock. In other words, within 2 years after the Lehman Corporation got started it brought back 33.7 percent of its own stock, and at what prices?

In 1929 it bought at an average price of $72.18, repurchasing 500 shares. In 1930 they repurchased 92,200 shares at $74.99. In 1931 they repurchased 140,200 shares at $46.29.

How about that fellow whose stock they bought back? He did not have $134. He got $46.29 for his $104. And that was the situation with respect to 140,200 shares.

In 1932 they bought back 98,000 shares at $34.31 a share. That fellow did not get $134 or $104, but only $34 for his $104.

And, similarly, in 1933 they were buying back their own shares at $41.65. The average price at which they repurchased all their shares was $50.79.

So that with respect to the holders of one-third of the total capital securities which Lehman Corporation issued, those fellows did not get $134 but $50.

One more angle: When they repurchased those shares they did not even pay the asset value to the fellow whose shares they were buying. Here was an individual who put money in the company. He says “You manage my funds.” After 2 years for some reason best known to himself, whether he needed the money, or had lost confidence, or wanted to buy something else, he decided to get out of the Lehman Corporation.

The fact of the matter is, if you will take a look at the fifth column on that page you will see that those shares were bought back at a discount of over $6,000,000. That means that they paid those shareholders $6,000,000 less than market value at the time.

Senator Taft. You mean asset value, do you not?

Mr. Schenker. Yes; I meant asset value. If the market value was $50 they really had $56 behind each share, and the company made a profit of $6,000,000.

What was the effect of these repurchases? The effect was that this discount amounted to $8.80 on every share outstanding today. So, the only thing they did was just to take from Peter Stockholder and pay to Paul Stockholder. So that when you consider the amount that is still left for the Lehman stockholders, you have to consider that $8.80 on each share was not due to management because they picked the right stocks and gave expert advice; they took the $8.80 from stockholder A who got out and gave it to stockholder B. And I am
talking about the best investment trust in this country. I am not being critical of them. I am just saying what we said in our report on performance, which Mr. Bunker said he read with great care, that difficulties in management of large investment accounts have long been recognized in connection with insurance companies, trust companies, investment counsel organizations, educational and charitable foundations or similar institutions, and detailed scientific studies have been made, and the appearance relatively recently of a considerable number of investment trusts have given us the opportunity of making a study. And then we say that, however, the full significance in the implications to the investor in the performance of investment trust companies cannot be completely evaluated until studies of these other investment institutions shall have become available.

You can make any comparison you desire; you can take the individual who invested in the Lehman Corporation, the best investment trust in the country, and can compare his experience with the fellow who bought Government bonds, kept his money in the bank or bought phony oil stock. I am not unmindful that there were people who bought such oil stock.

That is the reason why Commissioner Mathews, who is not prone to exaggeration and was one of our real outstanding commissioners, after a great deal of thought said (reading):

Speaking in general terms, the investment trust has not supplied capital to industry. The exceptions have been trivial and unimportant in their relation to our economy. Regulation cannot be charged with having the effect of stifling industry. Again speaking with individual and negligible exceptions excluded, the only real function which makes the existence of these institutions important to the country is that they supply a means by which a great number of investors may own a share in industry with such advantages as flow from diversification of investment and employment of expert management.

This is the sentence that I think is very important (reading further):

At their best, investment trusts serve these purposes. At something less than their best, the reputed advantages of diversification and of expert management are more than offset by the dangers which the mass of investors encounters in them.

Our only function is to see if we cannot be helpful in eliminating these dangers, because the problem of the investment company’s management is difficult enough as it is.

Senator Townsend. Have you placed in the record a list of the type of people who invest in these securities?

Mr. Schenker. On that aspect, Senator, we have done this. We have made a very detailed study of the average holding of the closed-end companies, and found that the largest number of stockholders hold shares worth about $500. I think in connection with the open-end companies the figure is about the same. When you come to the installment plan—and you have heard the elaboration upon that—and you get down to the class where they sell them at $10 a month and $10 when you can catch them. They sell to miners, servant girls, policemen, and get down to the lowest income brackets. In fact, they get down so low that they have told us that in many instances if the initial payment were $15 instead of $10 they could not make the sale, because the person did not have the extra $5. They get down to $2.50 a week. A fellow figures that he will give up a couple of glasses of beer and invest in these plans with their common stocks. As soon as the price gets up to $4 a week they cannot meet that obligation.
The most important vehicle for distribution of investment trust securities is selling on the installment plan. I asked one of them, "Would you think of selling these individuals a share of United States Steel?" He said, "No." Yet they take a package consisting of steel and other stocks and give the package a fancy name like thrift plan or saving plan and sell an interest in this package to these individuals in the lowest income brackets.

Senator Taft. I have got to go to the floor of the Senate, and I would like to ask you a question. On those figures of Lehman Bros.' repurchases will you attach to that the average asset value? You have given the discount from the original purchase price, but you have not given the discount from the asset value.

Mr. Schenker. That would be about $6,000,000, the discount from asset value.

Senator Taft. Is that stated in the list?

Mr. Schenker. Yes. They were buying it at $70 below the offering price and buying it at 25-percent discount from asset value, and that amounted to six-million-and-some-odd thousand dollars. It was $8.80 a share.

Senator Taft. Before they purchased, there was a market price. The stock was sold on the New York Stock Exchange?

Mr. Schenker. Yes.

Senator Taft. So their purchasing probably raised the price rather than lowered it?

Mr. Schenker. Shall I say, "stabilized" it?

Senator Taft. All right. But the tendency would be to raise the price rather than to depress it?

Mr. Schenker. Yes. Just give me one second. The repurchases in 1930 were approximately 11 percent of the total volume of the reported sales in Lehman Corporation stock on the New York Stock Exchange and the New York Curb Exchange, and the repurchases in 1931 were about 30 percent of the reported volume on the New York Stock Exchange.

During 1930 Lehman Corporation bought back its own stock at $50 when its offering price had been $134. What is the effect of that, Senator? I am not denying that they may have been distress sellers and were anxious to get out, and they may have been helped by these repurchases. But, on the other hand, people may have believed the Lehman Corporation is a fine corporation because of the good market behavior of its stock. Therefore you really do not get an accurate picture of the public's appraisal of Lehman Bros.' management, because the market price prevailing at the time does not represent the public's purchasing and the public's appraisal of Lehman Bros.; it represents the purchasing by the Lehman Corporation.

Senator Taft. Except that at the time of these large purchases there just was no market for anything. The bottom had just dropped out of the market—the same way the Government holds up farm prices. I think we had rather an extraordinary condition at the time of the big purchases.

Mr. Schenker. But this was not in 1929. It was in 1931 they bought 140,000 shares.

Senator Taft. That is what I say. The bottom dropped out in 1931, too.

Mr. Schenker. In 1932 they purchased 98,000 shares at $34.