I think the statement as contained in the committee print indicates it changed every 3 weeks that much, which is not true.

On page 142 of the committee print, right at the bottom of the page, the last sentence on the page, reads:

Of course, on days like September 5 you could buy the shares, pay the full load, sell them back almost immediately, and still make a substantial profit without any chance of less except to the trust.

That statement implies that you could do that with all trusts. It is not true that you could do it even on that day in the case of all trusts, because portfolio values did not advance sufficiently. That statement is true with reference to many of them, but not with reference to all of the 78 of which I was speaking.

Senator Wagner. All right, Mr. Bane.

Mr. Bane. When I appeared before you a few days ago, I attempted to explain the two-price system used by most open-end management type investment trusts in selling their shares or interests and the effects thereof on the trust and the investor.

I evidently was not as successful as I hoped I might be, for apparently the president of the distributor for the largest of these trusts, who was presented to you as the expert in such matters, doesn't understand it even after my explanation and his more than 15 years in the business.

I commented on the evils of the so-called two-price system employed in the day-to-day sales of the securities of these trusts which, as I explained, resulted in a cumulative dilution of the trusts, a dilution from day to day, from year to year, particularly in rising markets.

I submitted certain statistics compiled from the answers to questionnaires sent out by my division of the Securities and Exchange Commission to investment trusts of this type, that we knew were actively engaged in selling their securities in September 1939.

I tried to make it clear that the comments I was making upon the evils of this 2-price system applied generally to trusts of this type. I stated three or four times during the course of my remarks that more than 60 of the 78 trusts which were active not only allowed the interests of their existing shareholders to be continually diluted but that the 2-price method to which this dilution may largely be attributed was used by such trusts as one of their principal selling arguments.

I said:

The theory back of these trusts is that the new member should pay for his share an amount equal to the proportionate equity of existing shareholders at the time the new member comes in.

To phrase this theory somewhat differently: The existing shareholder has already an interest in securities in the portfolio of the trust; the new shareholder puts in cash which cash when invested in portfolio securities certainly should not reduce the existing shareholders' interest. In other words, when he buys in, if you will come down to what actually should occur, the new shareholder should get as much proportionate interest in the trust as his money buys of the portfolio securities after they are taken in.

Senator Wagner. And he gets more sometimes, does he not; I mean the new shareholder?

Mr. Bane. He may, if the market is not declining, and very few shares are sold in a declining market. About 90 percent of the sales are made in a rising market.
Senator Wagner. But the fund did not get all it should get.
Mr. Bane. That is right, the fund did not get what it should get.
Senator Wagner. That is what I meant.
Mr. Bane. The fund cannot and does not invest money it receives from sales of shares at the very moment the shares are sold. It does not even get the money at that time. It cannot invest the money the moment it receives it, either, as a usual proposition, but all these trusts, certainly those of the better type, boast that they keep in a fully invested position; that is, that they do not gamble on the market or bet against the course of the market. If instead of investing the funds at approximately the time they are received it holds them then it becomes not an investment fund but a gambling fund or vehicle for betting against the market.

Senator Wagner. Let me see if I can make myself clear. I hope I did not misunderstand the proposition. Let us say that the price was fixed on the morning, or the night before, and during the day the market goes up and yet the price which was fixed in the morning is still the price at 2 o’clock in the afternoon. Is that it?
Mr. Bane. At 12 o’clock at night, too.
Senator Wagner. I mean where you are able to buy.
Mr. Bane. You can buy at 12 o’clock at night.
Senator Wagner. So if I buy at that particular time on a rising market I get a greater interest in the fund than really I am entitled to, isn’t that so?
Mr. Bane. Than your money can duplicate in the fund.
Senator Wagner. Than my money can duplicate in the fund; yes.
Mr. Bane. Yes; that is it.
Senator Wagner (chairman of the subcommittee). You may proceed with your statement.
Mr. Bane. I attempted in no way to say how such trust shares should be priced and should be sold and I did not intend to suggest or imply any such thing in my previous statement. I intended only to show how trust shares actually are priced and how they are sold and the effects thereof. I am not speaking for the Commission. To my knowledge the Commission has not determined how these shares should be priced and sold, nor does anything in the bill indicate any such determination. And I have never heard the Commission discuss different ways of pricing; nor is there anything included in the bill, any proposal, as to how they should be priced. I presume if the Commission had had any such idea it would have made such suggestions to you for use in the bill.
In determining dilution, I took the difference between the known and established net asset value per share and the lower price at which the share was bought from the trust and multiplied it by the number of shares sold. This is the only practical method of determining that dilution.

Mr. Sanders and Mr. Traylor have indicated in their testimony that sales are made throughout the day. I believe that the committee has received an entirely erroneous and misleading impression from such statements. The cold fact is that the trusts which are diluted by this practice make sales in practically all cases at one time during the day to the distributor—always after a new price has been determined.
In order to clarify the two-price method, let me explain how trust shares are generally bought from the trust. The usual procedure is for the dealer or salesman upon receipt of an order to place it aside with other orders which he has or will receive. Near the close of the day the dealer or salesman generally will either send the orders in to the underwriter all at once, if the market is up, that is, if tomorrow's opening 10 a.m. price is to be higher, or conversely in the interest of so-called good execution if the price at 10 a.m. is to be lower, hold the orders over until the next day or some later day before sending them in to the underwriter so as to benefit his customer, or on occasion, himself. Thus having determined the "proper time" to send the orders in or have them executed to the disadvantage of the trust because of the two-price system, he sends his orders en masse to the underwriter or distributor. The orders must reach the distributor before the new higher price goes into effect if advantage is to be taken of the existing lower price. The distributor or underwriter gathers up any orders received and closes with the trust, i.e., "sweeps" the new sales into the trust before the new price goes into effect if the market has risen, but if it has fallen, holds them until the lower price is effective and then sweeps them in, or holds them over another day or two, as was true in one case I told you of in my former testimony, to see what the price situation will be.

Orders, when filled, are filled all at once by the trust; sales are not made throughout the day by the trust, irrespective of the time when the dealer or salesman made the sales. In substance, the trusts open once a day to sell shares. If shares are selling for less than they are worth, the orders are "swept" in and new shares issued. Any shares sold by dealers, salesmen, and the underwriters before the next "opening" and "closing" are grouped and either swept in if the new price is higher or held back another 24 hours if the new price is to be lower and so forth, day after day. Do I make myself clear?

Senator Wagner. You say it is just sold once a day?

Mr. Bané. Yes; as a general rule.

Senator Wagner. Suppose I want to buy a share. Of course you understand that I do not know about these matters as you do. If I want to buy a share have I got to wait for a certain time?

Mr. Bané. You do not have to wait at all. You give your order to the dealer. We will say the dealer takes your order this morning at 11 o'clock. He will send your order in to the underwriter some time after 3 o'clock this afternoon, after the two known prices have been determined.

Senator Wagner. Who is the dealer? Who do you mean by "dealer"?

Mr. Bané. The one who sold to you, for instance.

Senator Wagner. Where do I go?

Mr. Bané. You give your order to the dealer and get his receipt. Your order is sent in to the underwriter, the only one who can buy from the trust, as a general rule. The underwriter is the only one buying from the trust. He has that arrangement with the trust by which the trust agrees to sell to nobody but him. The dealer sends the order to him to be filled. Do I make myself clear?

Senator Wagner. Yes; I think you do.

Mr. Bané. The underwriter and the trustee each know what the old price is and what the new price to go into effect is. Thus there
are two known prices at the time the trust opens up and sells to the
underwriter. There are two price make-up sheets before them with
two different prices. The trust practically always receives less than
it should. If the lower of the two prices is the new price to go into
effect later, the trust sells no shares. The orders are held back for
24 hours.

Senator Wagner. As I understand, I put in my order to the dealer.
Mr. Bane. That is right.
Senator Wagner. At the higher price, I suppose, is it?
Mr. Bane. No. You put your order in, and—
Senator Wagner (interposing). Just to buy?
Mr. Bane. No. If the price is determined, for instance, on yester-
day's close, whatever that price was you buy so many shares at that
price today. You give that order to the dealer, and we will say your
order is for 100 shares at $5.60.

Senator Wagner. And let us say that the next day it is fixed at $4.
Mr. Bane. All right.
Senator Wagner. What do you pay?
Mr. Bane. You pay $5.60 unless, as some underwriters have
worked it out with the dealer, you put your order in to buy 100 shares
N. A. That "N. A." means just prior to the next advance. Or to
hold them S. L. if the market is looking down. Or you can send in
orders, as Massachusetts Distributors does, and have the order
marked to be executed at the lower of two prices after the new price
is determined. Then they will execute it at the lower price.

Senator Wagner. One other question right there.
Mr. Bane. Am I making myself clear to you?
Senator Wagner. Yes; let me go back to the $5.60. Let us say
that I make no condition at all. I want 20 shares of some particular
trust, and it is during the day that I put in my order, let us say at
$5. Now, at that time you say the dealer knows the price, it having
been fixed for the next day, and he knows that it will be $4? Without
my saying anything else what does he pay?
Mr. Bane. He will——
Senator Wagner (continuing). Does he pay $5 or $4. Does he
give me the advantage of the lower price?
Mr. Bane. Many dealers do, but some do not.
Senator Wagner. Does that mean that somebody else may make
that difference?
Mr. Bane. There is the difficult thing under this two-price system.
A dealer may very well protect his customer and give his customer
the benefit of the lower price, the $4 price, let him buy at the lower
price, hold back his order. And let us say that he does that for
the benefit of that particular customer. He gets him in the trust,
and he does it for the next customer, and when he does it for the
benefit of the customer he is now selling he is diluting the interest of
the man already in. In other words, he is working in favor of his
customer then coming in but to the disadvantage of the one he has
already sold to last month. The higher price in declining markets is
not received to offset in some degree this lower price received in
rising markets.

Senator Wagner. Then it is not so simple, is it?
Mr. Bane. No, sir; I do not think it is. [Laughter.]
Senator Wagner. All right; go ahead.
Mr. Bane. I said in substance in my previous statement that if there were a trust with one share of steel worth $55 in the portfolio and one investment trust share issued against it that the trust share would be worth about $55. I also pointed out that if during the course of the day the stock market rose on steel shares so that at 3 p. m. the steel share in the portfolio was worth $59, then the trust share would be worth about $59. I further pointed out that a man buying a steel share after 3 p. m. therefore, would pay $59. Furthermore, I said that investment trust shares are sold on an entirely different basis and that under the two-price system used by most companies a man could buy another trust share after 3 p. m. for only $55 when the outstanding trust share was worth $59.

Now, I stated that if a new share were issued by the trust after 3 p. m. for $55, when the outstanding share was worth $59, the trust was diluted or weakened $4 and that the old purchaser would lose $2 of the $4 appreciation which had accrued to his asset value. One trust share at 3 p. m. is worth $59. It is the only trust share outstanding. If the share of steel in the portfolio were sold the trust would have $59 cash. The trust share is, therefore, still worth $59.

Now, a second trust share is sold by the trust at 4 p. m. or 10 p. m. or 9:55 a. m. the next morning, for $55 when the one outstanding trust share is worth $59. The trust then has two shares outstanding with assets of $114, either a steel share worth $59 and $55 cash, or $59 cash if the steel share is sold and another $55 cash—in either event $114. If the second trust-share purchaser had paid $59 the trust would have had $118, but actually under the two-price system the trust only has $114.

This is not hypothetical or unreal: $114 divided by two makes each share only worth $57. You have two shares outstanding—each share is worth $2 less than it should be worth. If each outstanding share is worth $2 less than it was and should be worth, the trust is weakened or diluted $4. The dilution is $4. This is how we determined trust dilution.

And further, let us note the effect, or what really happens to the new purchaser who bought at $55 and was sold upon the representation that the interest that he was buying was worth $59. As I pointed out, as soon as his contribution was put into the trust or stirred in, as it is called, his interest was worth only $57, $2 less than he thought he was getting. Thus there is involved in such cases in addition to a dilution of the old shareholder, a deception of the new shareholder and a sale to him upon a represented value in excess of what his interest in the trust will actually be worth when his contribution is put in. Many of these trusts redeem shares presented during the day upon the basis of the net asset value determined at the close of that day, although the new offering price based upon this net asset value does not start until 10 a. m. the next day. In such trusts a person who bought a trust share at 3:30 p. m. for $55, could redeem the share almost immediately for $59. This leaves the old shareholder with assets of only $55; his whole appreciation is taken away and there are not enough assets left for him to redeem at the value he has the right to redeem at, namely, $59.

This is an accurate illustration of what actually happens in these trusts under this two-price system, the difference in particular cases being one of degree only caused by the size of the portfolio, the number
of shares sold, and the difference between the two daily prices. I explained that the two-price system was used by practically all open-end companies now selling and how, with the redemption provisions, in many instances, it resulted in providing one understanding the system, which few people do, a means for absolutely riskless trading to the detriment and further dilution of the trust and that some dealers and some insiders take advantage of it.

I told you that the trusts covered by our survey showed that from September 1 to September 22, 1939, of approximately 60 trusts, 35 reported paying out on redemptions $338,119 more than they received for the same shares which had been sold in September 1939. Total sales in the 3-week period aggregated approximately $24,000,000 and redemptions approximately $8,000,000 despite the bullishness of the market.

It seems fair to state that the heavy redemptions, in a bull market, were largely the result of profit-taking by persons not interested in investments. The uninformed, primarily the small investor, did not realize his opportunity or take advantage of this opportunity for quick profit. On the contrary, the uninformed who constitute the bulk of investors, probably believed that the trustees or fiduciaries would look out for their best interests. They pay a management fee for such service and the prospectuses imply that the trusts are run for the benefit of the investor.

Mr. Traylor said that I—

cited the example of the shares of the open-end trust which on September 5 advanced in price from $5.60 to $6.70 and yet was sold to the public on the basis of a value of $5.60 even though their established and known value was $6.70 according to the S. E. C.'s testimony.

It is upon this illustration that the S. E. C.'s case in the matter of so-called dilution was very largely based. With all possible emphasis, I should like to say that this illustration is completely irrelevant as far as 90 percent or more of the open-end industry is concerned. It is also probably the most extravagant example the S. E. C. could have used. To employ Mr. Bunker's well-conceived analogy, this is most certainly a specimen and an exceedingly rare one at that, rather than a run-of-the-mine sample.

I want to emphasize to this committee that that example was in no sense a specimen but was a sample. The extent of the dilution is a matter of degree, but the principle is the same. It was not by any means the most extreme example that could have been used so far as the difference between the known price and the price at which the shares were sold is concerned.

The difference in the illustration I used was $1.10; the difference in the case of Boston Fund, Inc., of Boston was $1.50 and in the case of Massachusetts Investors Trust of Boston $1.22. These latter two trusts are distributed by Mr. Griswold's company.

I had thought of giving you some examples but perhaps it would be better not to cite individual cases. I will simply say that this difference runs from $1.22 to $2.30 per share in some of the companies.

Mr. Traylor in his testimony criticized the method I used in determining dilution. He spoke of a purchaser buying a trust share at approximately 11 a.m. for $20 when it was worth $20.19, causing a 10-cent dilution for each share sold. He then said that if the market closed at 3 p.m. at such levels as to make the trust share worth $20.30, the S. E. C. contended that the purchaser should pay $20.30 and that there was 30 cents dilution per share.
The S. E. C. contends nothing. Mr. Traylor failed to continue this explanation through a 24-hour period and to tell you about shares sold by the trust after 3 p.m., which, as I previously explained, is practically always the case. When it was actually known that the per-share asset value of the portfolio was $20.30 and its shares were sold thereafter by the trust for $20 per share, there was a 30-cent dilution per share to the trust.

He left a very misleading impression when he intimated that a share in his trust was or ever has been sold to an investor at 11 a.m. by the trust. It never happened. Mr. Traylor's firm has the exclusive right to purchase from the trust and no individual can buy directly from the trust at 11 a.m. or any other hour. He also implied that the trust received the money at 11 a.m. the same day. It does not. Until very recently shares were sold once per day only by his three trusts—at approximately 10 a.m. each day—which was 43 hours after the market closed on which the price was based. The two-price system allows purchasers and traders a 43-hour lag after the market closes on which the price is based.

In most of these trusts, the insider and dealer does not have to pay the full load, but buys at a figure close to net asset value. Large purchasers often have the same advantage. If the market appreciation is in excess of the charge to such persons, they have a trading advantage not available to the general public who bear the full load.

It is true that in a large trust such as Massachusetts Investors Trust now is, and which has grown large while using this two-pricing system, the percentage of dilution resulting from this practice for any 1 day, however exceptional that day may be, seems small when compared with the total assets of such trust built up through many years of sales while using the two-price system.

Naturally the larger the trust, particularly as to number of shares outstanding and total assets, the smaller the percentage of dilution may be, but remember that this dilution on September 5 relates to but 1 day. The abuses from this practice go on day after day, month after month, year after year.

As I previously said, it is impossible to determine how much additional money would be in these trusts for investors if shares had not been sold continuously at a price below their known and determined value at the time of sale by the trust. We know that for 1 day in September in the case of Massachusetts Investors Trust it would have amounted to over $170,000 and for the 3 days of September 5, 11, and 19 it would have amounted to over $182,000.

While it may be true that the volume of sales by these trusts on September 5 would not have reached the proportions they did had the offering price reflected market appreciation, as Mr. Traylor indicated in his criticism of my previous testimony, it is true that had the offering price reflected the market appreciation there would have been no dilution, no matter how large or small the volume of sales. Furthermore, the old stockholders would have retained the full appreciation value to which they were rightfully entitled, and if no sales had been made the assets would have been divided among a smaller number.

Now I want to take some of the percentages and figures presented to you by Mr. Traylor, the distributor of the largest of the open-end investment trusts, an expert in pricing and figuring trust shares. He
testified, referring to dilution on September 11, and 19, 1939, and I quote:

According to the Securities and Exchange Commission testimony, total dilution on these 2 days was $176,000 for the industry.

Now this is most illuminating—in relation to the value of shareholders' interests (some $500,000,000)—

And, remember, that through here we are talking about hundreds of millions of dollars, at times. To continue the quotation:

the so-called dilution figure of $176,000 for the 2 days picked by the Securities and Exchange Commission amounts to 0.00035 percent, or about thirty-five one-thousandths of 1 percent. On an annual basis, this would come to about five one-hundredths of 1 percent—and if we double it to take care of a few semi-abnormal days, it's only one-tenth of 1 percent—and if we triple it to take care of a few more, it's still only fifteen one-hundredths of 1 percent.

That, gentlemen, by the direct process of employing the Securities and Exchange Commission's language and figures on a basis which has a significant meaning, is the so-called dilution problem in a nutshell.

I do not really know that I understand him. Does he mean—thirty-five one hundred thousandths of 1 percent which he has in figures or thirty-five one-thousandths of 1 percent as he has written it out, and by the way, he read it to you as thirty-five ten thousandths of 1 percent.

But let us assume that he meant the figure, thirty-five one-thousandths of 1 percent which is correct for $176,000 and $500,000,000. Now let us look at his next statement—"On an annual basis, this would come to about five one-hundredths of 1 percent." On an annual basis he means but one thing, that is, he assumed 300 sale days in a year and there being 2 days involved here in this $176,000 figure, he multiplied by 150 to obtain his annual basis, and what does he say it gives you? "Five one-hundredths of 1 percent."

Now, what actually is 150 times thirty-five one-thousandths of 1 percent—simple multiplication—it is 5.25 percent or 5½ percent, just 100 times the percentage he told you, and what is it in dollars? 150 times $176,000 amounts to $26,400,000 which is 5.25 percent of $500,000,000.

Now, if we double it to take care of a few semi-abnormal days, as he did, it is not one-tenth of 1 percent, but $52,800,000 or 10.56 percent, and if you triple it to take care of a few more days as he did it is not fifteen one-hundredths of 1 percent, but $79,200,000 or 15.84 percent.

I made very clear, I thought, in my previous testimony that I was talking about and giving you figures with reference to only those companies covered by our survey of the September situation—some 78 in number, of which approximately 59 diluted their trusts on September 11 and 19, and that the figures I gave you applied only to those companies. This, I thought, was very clear from my testimony. Therefore, the comparison of the dilution figures for only those 59 companies with the total value of shareholders' interests for all open-end companies as taken from Moody's Manual, many of which are not selling, is extremely misleading, unfair, and unjustified.

Let us make the same comparison as made by Mr. Traylor between the dilution on these days and the total value of shareholders' interests in these 59 trusts: Such shareholders' interests amount to approximately $408,854,314. The dilution figure of $176,000 for the 2 days compared with this, amounts to 0.043 percent. On an annual basis as used by Mr. Traylor, this would amount to $26,400,000 or 6.45
percent. Now, if we double it, as Mr. Traylor did to take care of a few semiabnormal days, it would amount to $52,800,000 or 12.90 percent; and if we triple it as Mr. Traylor did to take care of a few more, it would amount to $79,200,000 or 16.35 percent; and remember this goes on year in and year out.

To quote Mr. Traylor again—

That, gentlemen, by the direct process of employing the S. E. C.'s language and figures on a basis which has a significant meaning, is the so-called dilution problem in a nutshell.

When Mr. Traylor used as an example what he claimed to be the biggest open-end trust in America and figures percentage dilution per share of that trust on a basis of his having closed sales at 4 o'clock, it is no fair indication of what would have happened had sales at the old price continued beyond that hour.

The reason Mr. Traylor stopped selling at 4 o'clock on September 5 was because under his contract with his security holders he had agreed if the Dow-Jones industrial averages changed more than $5 in 1 day, he would stop selling. That day it changed more than $5. The reason for him making such an agreement was the disastrous dilutive effect he realized dilution had upon the trust when it went beyond that amount—if the change is 1, 3, or 4½ dollars it is only a difference in degree:

On September 11, and September 19, he made no such stop nor effort to prevent sales. He continued sales under the two-price system because the Dow-Jones industrial averages did not change more than $5.

Mr. Traylor said that “any dilution that occurs (usually during the periods of violent market movements) takes place in spite of the precaution taken to avoid it.” As a general rule there is no precaution taken by the open-end industry to avoid this dilution. Securities are deliberately and knowingly priced and sold upon a basis that can do nothing but dilute the interests of existing shareholders, and even in periods of violent market movements no precaution is taken, as a general rule, by these trusts to avoid dilution.

Specifically, these trusts not only took no precautions to avoid dilution of their shareholders on an unusual day like September 5, but on the other hand, as I before testified, many of them urged their dealers by telegram and telephone to greater efforts in making sales.

I should like to read two or three of the telegrams sent in September by this type of trust to its dealers:

New price 33.06, accepting orders old price 30.68 subject confirmation until midnight.

Another one:

Still accepting orders old price 30.68. Spare no effort. Will advise any change.

And I quote from another one:

Up 4½ cents again. Moved up faster than Dow-Jones composite average due about 98 percent invested position with approximately 90 percent of assets in stocks that should benefit from European situation. If order placed before 10 a. m. Saturday extra 2 percent above regular compensation, equal to about one-fourth of load which means considerable saving to investors or an extra margin on trades for those interested in market at this time.