

The study of these companies has been made by the Commission as directed by Congress, and I wish to point out in a general way what the study has disclosed. Before I do this, however, I wish to make it clear that I am not here to say to the committee that all investment trusts and all investment companies are bad, or that all men in the business are untrustworthy. Nor do I want to imply that all the evils and malpractices which we uncovered, and which we will discuss in detail, existed in all types of companies to the same degree or extent, or that some improvement has not been recently attempted by various companies. But I must say, because it is the truth, that, considered as a whole, the record of the industry is shocking. The most pessimistic prophets of the dire consequences to the investor of unregulated investment trusts have been justified.

I shall not now attempt to rehearse the numerous abuses which the study has disclosed. They will be explained to you in some detail later in the hearings. However, on the basis of the record, I am constrained to state that too often investment trusts and investment companies were organized and operated as adjuncts to the business of the sponsors and insiders to advance their personal interest at the expense of and to the detriment of their stockholders. Too often, sponsors and managers and insiders disregarded their basic fiduciary obligation to their investors.

Subordination of the interests of security holders to those of promoters and management takes many forms. I am not speaking merely of the instances of outright embezzlement. I am referring to the unloading of worthless securities and other investments of doubtful value upon the companies; to loans which investment companies have been caused to make to insiders; to the bail-outs of insiders from dubious and illiquid investments, from onerous commitments and from trading accounts. Investment companies have been compelled to finance banking clients of the insiders, and companies in which they were personally interested. Some investment companies are organized to be operated essentially as discretionary brokerage accounts, with the insiders obtaining the brokerage commission. In many instances the abuses are more subtle but just as injurious to the investor. The public's funds are used to further the banking business of the insiders, to obtain control of various industrial enterprises, banks and insurance companies, so that the emoluments of this control will flow to these controlling persons, and otherwise to serve the personal interests of the sponsors and management.

Another flagrant abuse is the organization of investment trusts and companies as manufacturers of securities, so that promoters in the distribution business can sell these securities regardless of the economic soundness of the trusts. Securities have been peddled from door to door like so much merchandise.

Insiders have also engaged in practices which permitted them to obtain large profits without any risk, by trading in the securities issued by the trust, to the pecuniary detriment of their investors. That may sound almost impossible, but representatives of the Registration Division of the Commission I think will prove it to the full satisfaction of this subcommittee. To increase their distribution profits and management fees, these insiders engaged in distribution practices which resulted in substantial dilution of the investors' interests.

To permit these promoters and insiders to accomplish these personal gains and to insure their control of the public funds without the necessity of substantial investment of their own funds, the charters of many of these companies have been so drawn to allow the insiders to deal as principal with these trusts and companies and contain the broadest exculpatory clauses. Complicated capital structures have been devised. Tricky management stocks with disproportionate voting power are issued to insiders. Voting trusts are created. Insiders give themselves long-term management contracts. Boards of directors often consist solely or predominantly of representatives of banking, brokerage, or distributor sponsors.

So too, after investors have invested substantial sums in companies on their faith in the reputation and standing of the existing managements, the insiders have frequently transferred control of the remainder of the public's funds to other persons, without the prior knowledge or consent of these security holders. Trafficking in control of investment trusts has reached surprising proportions. The investor in many instances has been kept in ignorance of these occurrences because of the inadequate or even deceptive character of the companies' reports to their stockholders.

The seriousness of these abuses is intensified by the fact that holders of investment company securities are peculiarly investors in the low-income brackets—the least sophisticated of investors. As I have indicated, during the relatively short period of their existence in this country investment trusts and companies have lost vast sums of money. The persons who paid for these losses constitute a class of investors who could least of all afford them.

These are not the evils and abuses of the past. The fact is that during the very course of the Commission's study some of the worst wrongs were perpetrated. The Commission had one particularly interesting experience. At one of our public examinations two witnesses were describing the manner in which they had depleted the assets of some investment trusts which they had formerly dominated. We later learned that these same individuals almost literally took time off from our public examination in order to complete their arrangements to loot some other investment trusts which had come under their control. I am happy to say that they are under indictment for it.

I am convinced, as is the entire Commission, that unless these companies are supervised they will represent a source of injury to the investor exceeding any social or economic function they may serve. I realize that this is a grave assertion for any man to make about any industry, and I make it in all seriousness.

It should hardly be necessary to point out that existing legislation is not adequate to meet the problems presented by the investment company. The mere recital of the abuses which have occurred since 1933 and 1934, tends to prove that the Securities Act of 1933 and the Securities Exchange Act of 1934, valuable as they are in most fields, are inadequate here. Because of the peculiar character of investment companies and their resemblance to savings banks, mere disclosure is inadequate as a remedy. Indeed, in many instances even publicity has not been achieved, since numerous companies have not found it necessary to register their securities with the Commission under either Act. The disclosure principle embodied in the Securities Act

and Securities Exchange Act is a sound principle, but it has its limitations. Let me quote from a leading editorial which appeared in the New York Times on November 12, 1936:

Many investment trust officers would stop here, (publicity) holding that 'bright sunlight' is all that is needed, and that once this is brought to bear on trust affairs the investor himself must make his choice. But the experience of the last decade indicates that more than this is needed.

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Among the principal abuses of investment trusts have been their use as dumping grounds for unmarketable underwritings participated in by the banking house controlling the trusts; the too rapid turning over of their portfolios (often with the object of obtaining commissions for the banking house); a complicated financial structure; the acquisition of highly speculative instead of sound dividend-paying stocks; and the excessive concentration of investments in one or a few companies. Most of these abuses would not be difficult to correct. There are also other practices the wisdom of which, on grounds of public policy, is at least open to debate. These include, for example, the purchase of so large an amount of the stock of particular companies that the trust has a dominating voice in the management of those companies. Investment trusts, in any case, are as properly subject to regulation as savings banks and insurance companies. Such regulation has been long overdue.

The conclusions and recommendations of the Commission are not based on any cursory, haphazard sampling of the industry. Rather the study, at least in my opinion, is a comprehensive and objective survey of all the types of investment trusts and investment companies which exist or have existed in this country.

[As I have stated, from its inception I was given general supervision of the study.] Paul P. Gourrich was made director of the study. (He resigned because of ill health in March 1939.) William H. Spratt, Jr., was made chief of the study and David Schenker was made counsel. We recruited a staff of accountants and men with some experience and training in the investment trust field. Unhappily, Mr. Spratt had to submit to a major surgical operation. He failed to rally from it and died, largely, I believe, as the result of overwork and sticking too long to his post of duty.

We did not complete the study and report within the time mentioned in the statute. In that connection we must accept a reasonable amount of criticism. The fact is, however, by way of explanation and not of excuse, that the size and the problems of the industry proved to be much larger or more complicated than either we or Congress evidently anticipated. Moreover, during the course of the study many changes took place in the industry itself. In addition, when we were nearing the completion of our study, in fact after we had completed our public examinations, several investment companies were literally looted, and we had to reopen our investigation and conduct further hearings.

I would like the members of the subcommittee to know what our methods were in conducting the study: We prepared tentative questionnaires for each of the various types of companies and, as the Senators will see, there are a good many different types. We asked the various branches of the industry to organize committees to consult with us. They did so. We submitted the tentative questionnaires to them and considered all of their suggestions and then put the questionnaires in final form. The industry's committees did not give the questionnaires any formal approval, but they made very little objection to them.

Most of the information and data were accumulated from answers to these questionnaires. By the end of 1937, the Commission had received replies from about 700 trusts and companies of all types and from about 400 investment advisers. In addition, field studies were made of about 60 companies, which has been acquired and absorbed by two large investment companies during the period 1927 to 1935.

In addition to that, we sent accountants and examiners into the field to study the books and records of about 100 companies. Furthermore, we examined various State and court records of about 100 companies. Furthermore, we examined various State and court records to learn what we could about various lawsuits involving trusts and the history of various trusts which had become defunct. All in all, we collected our material from a great variety of sources.

After the examinations in the field and study of the questionnaires the staff prepared a detailed preliminary report on each company. The report was submitted to the company and its representatives were invited to come and talk with the staff about the report; and nearly all of them did so. The result was to promote better understanding of their problems on our side, and also to afford them an opportunity to explain away, in some instances at least, facts which, superficially and unexplained, seemed a good deal more sensational than they turned out to be. However, as the Senators will hear, there was no ultimate scarcity of examples of shocking abuses. These conferences also had the virtue of preparing the companies for public hearing by letting them know what topics they were expected to testify about and what papers and records they were expected to bring.

In general, the next stage was the public examinations, which were held on 250 companies—practically every company which had \$10,000,000 or more of assets. In these public hearings the companies examined were entitled to be represented by counsel, to cross-examine witnesses produced by the Commission, and to present evidence through witnesses of their own choosing.

The record of these public examinations consists of 33,000 pages of transcript and 4,800 exhibits. The record was not ordered printed by Congress and therefore is only available in typewritten form. I think this is regrettable.

From time to time, we have sent reports to Congress embodying the results of our study. We referred to our main report as the "over-all" report which consists of four parts.

Part I of this over-all report, which we sent to Congress on the 10th day of June 1938, was entitled "The Nature, Classification, and Origin of Investment Companies."

Part II was entitled "Statistical Analysis of Investment Trusts and Investment Companies." This part, consisting of eight chapters, analyzes the companies on a detailed statistical basis as to performance, earnings, trading in portfolio securities, investors' experience, and so forth. Before submitting our chapter on performance to the Congress, we decided we would like a check on our statistical methods by an independent expert. Dr. Edwin B. Wilson, of Harvard University, an outstanding statistician of national reputation, was selected for this purpose. He examined the report and wrote us that "it was a thoroughly sound and substantial job."

Part III was entitled "Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies." It consists of seven chapters. It discusses, as the title indicates, the evils and malpractices of all the investment trusts and companies which we studied. All these chapters, except a part of the accounting chapter and a chapter containing a further elaboration upon the abuses in the management of assets, have already been transmitted to the Congress.

Part IV, entitled "Economic Significance in Control of Industry," is an elaboration of those phases contained in the statistical portions. This part is in the process of being completed and will be transmitted to the Congress in the near future.

The Commission in addition has prepared and sent to Congress six supplemental reports dealing with (a) fixed trusts; (b) installment investment plans; (c) British investment trusts; (d) investment advisory services; (e) common and commingled trust funds operated by banks and trust companies; (f) companies issuing face-amount installment certificates. The latter is in page proof at the Government Printing Office and will be available in about 2 weeks.

In this connection I should like to state that in our recent report dealing with the accounting practices of the United Founders Companies, an expression of ours concerning accountants has unfortunately been interpreted to mean that we think the mere fact that an auditor is paid by the corporation he audits destroys his independence. This is a misinterpretation. We take no such view. We did wish, however, to call attention to the possible effect upon the auditor's complete impartiality of the fact that he is usually both selected and paid by the management. We wished to emphasize the fact that he is selected and paid by the very management whose financial acts he undertakes to audit and appraise. We wished to emphasize the primary obligation nowadays of the auditor to act for the security holders, and to lay a foundation for the provision contained in this bill requiring independent auditors to be selected by the stockholders. The value of this provision, I believe, is principally psychological. I hope that it will have the effect of keeping constantly before the auditor the realization that he acts principally for the stockholders and that in these modern days of widespread stock ownership he is not acting merely for the information of the directors or the discovery of peculations of employees.

The reports of the Commission already transmitted to the Congress cover every phase of the industry's activities. Before the Commission finally crystallized its recommendations, the staff of the investment trust study held numerous conferences with the representatives and committees on all branches of the industry, lasting over many days, and the Commission itself spent many hours in conference with these representatives, considering their various ideas and recommendations and reviewing their extensive written suggestions. This is in addition to the many hours which the full Commission has spent with the staff. The suggestions of the industry have thus been thoroughly canvassed and we have given careful consideration to all of their objections and suggestions.

I have not learned that there is a substantial opposition of the industry to the idea of Federal regulation. I do not mean by this that the representatives of the industry have approved the bill. We

made known our willingness to discuss it with them in detail after it was introduced, but with a few special exceptions they have not chosen to accept our invitation. Of course they were within their rights there. I gather from the press that there are various sections of the bill to which objection is made. Personally, I regret that after the bill was printed the industry did not see fit to confer with us.

The objectives of our participation in these hearings is to lay before the Congress, in addition to the printed reports, which busy members do not always find the time to study in detail, such information and recommendations as we have. We realize fully, that the enactment of a bill is a responsibility of the Congress, and not of the Commission. It is our responsibility, however, to lay before you as frankly and as fairly as we can the facts which we have gathered and the views at which we have arrived.

Our plan of presentation is that at the conclusion of my statement various members of the staff and individuals not connected with the Commission, whom we will suggest that you call, will try to "high-spot" and epitomize the outstanding facts which have been developed in various situations. A brief synopsis—too brief, I fear—of the statistical analysis will also be presented.

We take no special pleasure in parading before this committee the unwinsome remnants of the evil or careless deeds of some of the investment-trust sponsors and managers. We do it because it seems necessary to do it, in an effort to prove the need of regulation and to give the committee an adequate basis upon which to form a judgment on the differences of opinion between the Commission and the industry, which will be made known as these hearings progress. I personally am convinced that without legislation which at least approximates this bill the abuses and deficiencies in the industry as a whole will not be eliminated.

We shall also call to the attention of the committee various bills in equity which the Commission has brought against various investment trusts to enjoin the sale of securities of trusts by methods which are, to say the least, questionable. Some of them went to trial. More of them resulted in consent injunctions. We didn't ask them to consent; I assume they consented because they wanted to. The Commission has also had a number of stop orders against companies which have registered, or attempted to register, under the Securities Act of 1933. They will be described by members of the staff of the Commission. We shall also bring to the attention of the committee a number of criminal cases, some of which grew out of the Commission's investigations, some of which are still pending, and some of which have resulted in convictions.

I would like to state in a very general way what the objectives of the legislation are. The details of the legislation if you indulge my plan will be discussed by the various members of the staff who are more familiar with the technical details than I am.

First of all, we realize, as I have already stated, that the bill is the responsibility of Congress. I have seen enough of the legislative process to know that bills, like plays, are not written but rewritten. At the same time, I believe that this bill is a reasonable and a fair bill. My personal opinion is that some provisions are somewhat too lax. The mildness of many of its provisions has provoked approval

in some quarters and criticism in others. We want to be fair and reasonable to the industry; we also want to be fair to investors.

In general, various commentators, without approving of all the details of the bill, have said that it gives the general impression of a mild and well-considered measure. Among these may be noted the New York Times, the Christian Science Monitor, and the St. Louis Post Dispatch.

Before I point out some of the things that this bill does, I should like to point out some of the things it does not do.

In the first place, the bill does not attempt to set up an ideal form of investment company and then compel all companies to conform to the ideal. Its provisions have been scrupulously adapted to the existing diversities of investment company organizations and functions.

In order that the committee may fully appreciate the varying forms which investment trusts and companies take, let me briefly describe the various types. And I think when you listen to the description of the various types you will realize why it has been difficult to draw a bill, there are such variations.

First, there are the management investment companies. The distinctive feature of these companies is that no restrictions, or only limited restrictions, are imposed with respect to the nature, type, and amounts of investment which their managements may make.

Management investment companies fall into two broad classes, the open-end and the closed-end type. The peculiarity of open-end companies is that they issue so-called redeemable securities—that is, as security which provides that the holder may tender it to the company at any time and receive a sum of money roughly proportionate to the current market value of his share of the company's assets. Because of the exercise of this redemption feature, the assets of most open-end companies would constantly be shrinking if they did not constantly sell new securities to new investors. It is because of this constant sales activity that these companies are called open-end companies. Presumably, the name was suggested by the familiar term "open-end mortgage." Closed-end companies are management investment companies which do not have this redemption feature. They do not distribute their securities continuously but only from time to time as they need new capital. Up to 1929 nearly all investment companies were of the closed-end type. However, the open-end companies, though a relatively recent development, have expanded rapidly and now have total assets whose value is approximately two-thirds of the value of closed-end assets.

Then there are the fixed or semifixed investment trusts. In this type management discretion is completely or almost completely eliminated. The investor is sold an undivided interest in a specified package or unit of securities which are deposited with a trustee. The underlying securities cannot be changed at all, or can be eliminated only upon the happening of certain specified contingencies, such as the passing of a dividend on any security in the package for a prescribed period of time, the reduction in the investment rating of the security by a prescribed statistical service, and similar reasons.

Another type of investment company is the so-called installment investment or periodic payment plan, which is in essence a device to sell investment trust or investment company shares to the public on the installment plan. These plans were designed to tap the savings

of individuals in the lowest economic and income strata of the population for investment in common stocks. Some plans provide for installments as low as \$5 a month but the usual payment is \$10 a month, and the period of payment is generally 10 years.

The final variant of investment enterprise studied by the Commission is the so-called face-amount certificate company. Although these companies have been in existence in this country since 1894, the greater portion of their certificates have been sold since 1929. In essence the certificates sold by these companies are contracts between the corporation which issue them and the purchaser, whereby in consideration of the payment of certain specified installments the corporation agrees to pay to the purchaser at maturity a definite sum, the "face amount" of the certificate; or to pay prior to maturity a specified surrender value of the certificate. As in the case of installment investment plan, the selling commissions or "load" on the face amount certificate are taken out of the installments paid within the first and second years. As a consequence, the surrender value of the certificate during the early years is small and the investor who defaults or permits his certificate to lapse sustains a substantial loss. Though there are relatively few companies in this field, they are quite large. The two largest companies and their subsidiaries have aggregate assets in the neighborhood of \$190,000,000 and have outstanding certificates with a face amount of over \$1,000,000,000—the amount which these companies will have to pay if all investors make the required payments in the meantime.

The bill does not attempt to tell investment trusts that they can or cannot engage in this or that activity. There is not the slightest conscious effort to circumscribe or restrict the initiative or the enterprise of managers. The bill does not attempt to say to the investment trust, "You cannot make this or that kind of investment." It does attempt to say, "If you regularly make this or that kind of an investment you must make disclosure and obtain your stockholders' consent to this fundamental business; you must wear the label appropriate to your business; and you must conform to the type of regulation that is most appropriate for your kind of a company."

For example, the bill does not prohibit investment companies from actively trading in securities or engaging in underwritings. However, we feel very definitely that a company which risks a substantial part of its capital in underwriting, or a company whose principal business is to speculate actively, should be clearly labeled as such a company and should have the consent of its security holders to engage in these activities.

The bill does not attempt to compel investment companies to change their existing outstanding capital structures, or to simplify their existing pyramided investment company systems. It does provide, however, that in the future these companies shall issue only common stock, except in connection with consolidation, mergers, and reorganizations.

Nor does the bill require the segregation of investment bankers, brokers, and distributors from the management of investment companies, a step which various officials of investment companies themselves advocated in the hearings before the Commission. However, to prevent the evils which may result from the divided loyalties,