certain specific restrictions are imposed on affiliations involving conflicts of interest.

The bill does not prohibit management contracts although there was expressed by many officials the opinion that they should be abolished. It does require that management contracts meet certain specified conditions. Now I move to a slightly different topic connected with the bill.

Undoubtedly, before the hearings are over, there will be considerable discussion, and properly so, as to the amount of discretion which should be given to the Commission. My immediate observation is about as follows:

First of all, it seems to me that the greatest virtue of the administrative process is flexibility. I think it would be unfortunate to throw it away. A good deal of the criticism of it is based upon the false idea that the rule-making power is the power to make laws. We do not have the power to make laws. No one has the power to make laws except Congress. The Schechter decision by the Supreme Court reminded us of that fundamental principle. Congress may lawfully, however, authorize us to make rules to implement already existing laws according to prescribed standards. Despite the views that I have expressed, if Congress believes that it can write flat prohibitions into this statute which will stamp out abuses and which will not do injustice to the honest persons in the industry, that's all right with us. The fewer discretionary decisions we have to make, the easier our administrative job is. I shall not be surprised, however, if as the hearing develops you find situations where rigid prohibitions cannot be drawn and where the industry and the Senators will find that it is necessary to put a little rubber into the bill for the exceptional, unforeseeable and unpredictable cases. For example, I doubt the wisdom of undertaking to write into the bill itself uniform accounting standards for all investment trusts. It isn't a job that I would relish very much. There is, it seems to me, but one sensible way to approach problems of that nature. Give the power to the Commission and then let the Commission work it out in conference as a joint enterprise with the industry and the representative accounting firms and societies of the country. I assume, of course, that the Commission should be given the power to promulgate rules relating to its own practice and procedure.

It seems to me that in the face of problems of that kind and of practical necessities that it is unwise to take all flexibility out of the act. I doubt whether the committee can solve these difficult problems by the rigid rules of statute. I doubt whether the industry believes it can be done. By way of illustration, I would like to say from actual experience that if the Securities Exchange Act of 1934 had not given us very flexible powers of exemption, the utmost confusion would have existed in the early days of registering stock exchanges and the thousands of listed securities traded on those exchanges. We had to resort to this exemptive power for a temporary period in order not to interrupt trading and in order finally to reach the statutory objective of registration, and I think it is highly significant, and I would like to emphasize at this time, that much of the flexibility of the Exchange Act of 1934 is due to the insistence of the exchanges themselves, expressed before the committees of Congress, as the reports of the congressional committees clearly show at the pages which are specified

in my printed copy of this statement. (H. Rep. No. 1383; 73d Cong., 2d sess, pp. 6–7).

Further, with respect to the substantive provisions of this bill, I do not propose to discuss these in detail, but I do wish to make two or three general observations about them.

In general, everyone seems to be pretty much agreed that the functions of the investment trusts should be to afford the small investor an opportunity to spread his investment risks by a diversification of security holdings, to furnish competent and continuing investment supervision, and to assist in making capital available for industry. In a great many instances these objectives have not been realized. The failure may be attributed to certain fundamental causes.

First, there has been no regulation with respect to the individuals who may organize and operate these companies. The bill provides for the registration of officers, directors, managers, and underwriters of investment trusts and companies. That does not mean that no one can occupy one of these positions unless his qualifications are approved by the S. E. C. The Commission would only have the authority to deny registration or revoke registration for certain specific causes, viz: (1) That the man had been convicted of a crime within 10 years; (2) that he is under injunction by a court of competent jurisdiction because of some wrongdoing in connection with security transactions; (3) that in his registration he makes a material misrepresentation to the Commission. The purpose of this provision is to prevent persons with unsavory records from occupying these positions where they have so much power and where faithfulness to the fiduciary obligation is so important.

Second, it is perhaps not too much to say that the disregard of fiduciary standards lies at the root of many investment-company problems. The fiduciary obligation of the management to stockholders is too often violated or disregarded. The bill undertakes to impose specific conditions which will insure the observance of this fundamental obligation.

Third, many investment companies have adopted complicated and precarious forms of capital structure. Under this bill they will be required to follow more conservative standards. In view of the nature and functions of these companies, I believe that there is no excuse for pyramiding or for more than one class of securities in their capital structures.

Fourth, adequate accounting regulation is in my opinion fundamental, if these companies are ever to serve the purposes for which they should be designed.

Fifth, some public supervision over mergers, consolidations, and other reorganizations is necessary for the protection of investors. The investor is singularly helpless under such circumstances. Every time, for example, there is a merger of the sort recently proposed between Atlas and Curtiss-Wright, we have a flock of letters from security holders who cannot analyze the exchange offers and do not know what to do. I think it is extremely helpful if some impartial body which has no money stake whatever in the outcome, but is in a completely impartial position, can write an objective, scientific analysis of those offers and put them in the hands of the stockholders, who will thereby, I hope, get some basis for making an intelligent decision.

This bill will, I believe, promote the dignity of investment trusts. The management of these institutions is worthy of being a separate profession and a separate charge in itself, instead of being a mere adjunct to some other line of business. What we ought to develop is a group of expert investment trust managers who do not make their profits from originating and distributing types of securities, styled principally for their sales appeal, but from wise and careful management of the funds entrusted to them.

I believe that a true mutual investment company subject to governmental supervision may be entitled to special tax consideration. At the present time, only open-end companies are the beneficiaries of this consideration. I feel that the basis of granting this favorable tax treatment should not depend upon the right of a security holder to compel the company to redeem his security but rather upon the more fundamental aspects of mutuality and regulation.

Finally, intelligent regulation is in the interest of the investment trusts and companies themselves, as well as the people who put their money into these organizations. I believe this bill will tend to restore public confidence in these institutions. These organizations could then perform the vital functions of furnishing honest and unbiased investment management to the large group of small investors who require this service. These organizations might then become a vital factor in furnishing capital for industry and the stimulation of national recovery.

Senator WAGNER. Thank you very much, Judge. Are there any questions?

Senator TOWNSEND. The Judge will be available in case we care to ask questions after we have had a chance to study this?

Mr. HEALY. I hope to be able to answer all the questions.

Senator WAGNER (chairman of the subcommittee). Mr. David Schenker, chief counsel for the S. E. C. Investment Trust Study.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION INVESTMENT TRUST STUDY

Mr. SCHENKER. Senators, the Judge's talk was entirely devoted to title 1, which deals with investment trust, and investment companies.

Senator WAGNER. Will you keep your voice up please?

Mr. SCHENKER. Yes. The proposed bill also contains a short title relating to investment advisers, which encompasses that broad category ranging from people who are engaged in the profession of furnishing disinterested, impartial advice to a certain economic stratum of our population to the other extreme, individuals engaged in running tipster organizations, or sending through the mails stock market letters.

Now, you may ask, "Where does the S. E. C. fit into this investment counsel picture? How did you come to make the study?"

Section 30 specifically directed us to make a study of the influence exerted by people affiliated with investment trusts and investment companies upon their investment policies. It became quite obvious to us that there were a great many of them and we felt duty bound to make that study.

Of course, our jurisdiction was limited to that peculiar phase. However, we did succeed in getting certain fundamental data, mostly

of a statistical nature, which gave us some inkling of the scope of the problem.

Now, we canvassed every source of information we could and we learned of the existence of 394 investment counselors. That, in my opinion, does not even approximate the number of people who are engaged in this profession, or business, or type of activity. After all, the only way we could get the list was through the telephone directories. But there are many who do not even have telephones or have their offices in their hats. We could not obtain any information about them.

Therefore, our fundamental approach to this problem is in the first instance, before we could intelligently make an appraisal of the economic function or of the abuses which might exist in that type of organization, to see if we could not get something which approximated a compulsory census. Fundamentally that is the basic approach of title 2. We first would like to find out how many people are engaged in this business, what their connections are, what is the extent of their authority, what is their background, who they are, and how they handle the people's funds?

Aside from that fundamental approach, the only other provisions in that title are just a few broad general provisions which say that you cannot embezzle your client's funds or you cannot be guilty of fraud. One other provision relates to the transfer of the contracts which a client makes with investment counsel. I will elaborate on those provisions at a subsequent date.

Senator TAFT. What is the constitutional basis for regulating a person who simply has an office in Cincinnati, for instance, and advises people to come to see him?

Mr. SCHENKER. Well, Senator, we intend to submit to the committee quite a comprehensive brief on the constitutionality not only of title 1 but title 2. I do not make a pretense of being an expert constitutional lawyer——

Senator TAFT. Title 1 has to do with an investment trust which buys and sells securities. That business is more or less interstate. However, I do not see how a firm that sets itself up as an adviser, like the Scudder, Stevens & Clark people, to whom people come and ask for advice, can be said to be engaged in interstate commerce.

Mr. SCHENKER. Judge Healy wants to elaborate on that, but I would like to try to answer that. It is not unlike our approach to the investment company title. If you believe in the constitutionality of the 1934 act, then the investment company is engaged in interstate commerce because of its constant use of the exchanges which are an instrumentality of interstate commerce. Similarly an investment counsel gives advice with respect to the execution of orders relating to securities listed on exchanges and in a great many instances has discretionary power to execute those orders. In addition, they have branch offices throughout the country. In addition to that, a great many of them—not all of them—conduct their business through the mail.

Senator TAFT. I wondered if it was just on the fact that the mail is used and nothing else. That, it seems to me, is a very thin basis for its constitutionality.

Mr. SCHENKER. Senator, our provisions——

Senator TAFT. I do not quite see how, if that kind of man is subject to the regulations of the Federal Government, every lawyer in his

legal business is not subject to the regulations of the Federal Government, and every doctor. He is certainly giving advice about things that relate to interstate commerce in many cases.

Mr. SCHENKER. Well, we have attempted to formulate an exemption which is consonant with your ideas. We have said that if the investment adviser maintains his business in one State and his clients reside in one State he is exempted. It seems to me necessarily that if his major function or his primary function is to give advice relating to the purchase and sales of securities listed on the stock exchange, which is an instrumentality of interstate commerce, then that fact, in conjunction with the power of Congress to regulate the mails, is sufficient to confer jurisdiction to compel these people at least in the first instance to tell that they are engaged in that business. That substantially is the whole extent of title 2.

Senator TAFT. Of course, many law firms are engaged in that business. Our office has a fairly large estate business and we are constantly called upon to advise and counsel as to investments. It is not something you might like to do, but you have to do it sometimes.

Mr. SCHENKER. Being a lawyer myself, Senator, I took particular pains to see that we were not included within the scope of this legislation.

Senator TOWNSEND. That point may bother a layman a little.

Mr. SCHENKER. I was not merely being facetious. You say, "Well, why didn't you include lawyers?" We felt,in the first place, since a lawyer is subject to the Bar Association and there is a high fiduciary duty on him——

Senator HUGHES. He is an officer of the court also.

Mr. SCHENKER. He is an officer of the court also.

Senator TAFT. There was not any scruple about leaving him out because he was not engaged in interstate commerce?

Mr. SCHENKER. Oh, we had difficulty with that problem too.

Senator WAGNER. I do not want to anticipate your testimony, but have you some instances of the activities of these counselors or abuses in connection with their activities?

Mr. SCHENKER. In a brief time, Senator, I think I can give you a short description or over-all picture of the industry. I have brought along with me copies of the report that we have submitted to Congress, and as I elaborate I will refer to the pages which deal with these subjects. You will be able to see what those problems are.

Senator WAGNER. Would you rather go on and have us ask questions later on? What is your preference about that?

Mr. SCHENKER. For 4 years I have been asking everybody else questions, and I think it only fair that somebody ask me questions now.

Senator WAGNER. That is fair.

Mr. SCHENKER. I say we learned of the existence of 394 investment advisers. Now, the estimates as to the number of investment counsel, of course, vary a great deal. Some estimates put the number at 10,000, some at 6,000, and so forth. Now, this is fairly important: We did not obtain detailed information with respect to all these 394 investment advisers that we found, for we were conscious of the limitation of our jurisdiction with respect to the scope of the investigation we could make. We felt we could only ask people who acted as investment managers to investment companies for detailed information. We tried to get some idea of the amount of funds that these people manage

or with respect to which they have some influence. We found that 51 out of 394 companies give investment advice and have influence with respect to $4,000,000,000 of funds.

Now, it is true that substantial parts of these funds are funds of banks and insurance companies. However, if you will take a look at pages 8 and 9 of the report, you will see that with respect to 49 of these firms, as far as the total amount of funds of individual clients is concerned—and that falls in the category of "other clients" in table 6—they handle almost a billion dollars of these funds. If you will look at the other two large companies, they have individual accounts of clients of $350,000,000. So that these 51 companies alone give investment advice and handle accounts of $1,350,000,000.

These investment advisers are virtually in every State. You can get the geographical distribution of these companies on page 6. These are the firms about which we knew.

In addition, we tried to get some comprehensive analysis as to whether these people devoted their time exclusively to giving investment advice or whether they were engaged in some other occupation. If you will look at page 11 you will see the variety of other businesses in which investment counsel engage.

These other businesses are brokers or dealers in securities, publication of investment manuals and periodicals, financial counsel, general business counsel, trust work, underwriting, business management, real-estate management, real-estate dealers, evaluation of securities, training analysts, holding company, insurance broker, estate planning, estate and tax counsel, import and export merchandise, industrial management and reorganization, investment bankers, mining, and so forth.

It is true that there are some people who feel that the investment counsel is in a profession just like the legal profession and that all the efforts and time and activities of this company should be devoted exclusively to the giving of investment advice. I will discuss an investment counsel association which has been formed and some of the things they hope to accomplish along that line.

Now, I cannot impress too strongly upon the Senators the fact that our title 2 does not attempt to say who can be an investment counselor, who can't be an investment counselor, and does not even remotely presume to undertake to pass upon their qualifications. All we say is that in order to get some idea of who is in this business and what is his background, you cannot use the mails to perform your investment counsel business unless you are registered with us.

What is this registration requirement? What does it amount to? It discloses their name and address, who are their partners, what is their background, what is their experience, what is their discretion over their customers' accounts, and we ask them if they engage in any other business. If they have been convicted in connection with a securities fraud or if they are subject to an injunction in connection with a securities fraud, we have the right—we are not under duty—after considering all the factors, if we think that the public interest would be injured, to say that "We will not register you."

Now, I have discussed this title at great length with the representatives of the industry. Of course, it is always difficult to presume to talk for somebody else. I think by and large that the people in the investment counsel business may perform a very valuable function.

But, Senators, what is the situation? The very wealthy man has his own private investment counselor. The individuals in the lower income stratum cannot afford any investment counselors, because the advisers usually charge a minimum fee. You have that tremendous population in between these two strata, people of moderate wealth, who feel that they are not competent to pass upon their investments. It is that portion of our population that these advisers can serve. And some want to do that job.

However, they are impeded in doing that job by the fact that there is a fringe of people who do not perform that function, but who, if I may use the expression, crash in on the good will of these reputable organizations which have the substantial research organizations, by giving themselves a designation of investment counselors. These individuals are nothing more than tipsters, who have outrageous arrangements with respect to profit sharing, and so on.

I think—and I say again I do not presume to talk for the investment advisory services—that the investment counsel industry would desire the simple approach of Title 2 in the first instance. I am not saying they may not have difficulty with some of the language or the way we phrased the provisions. I think you will find that is true with respect to the portion of the bill which relates to investment trusts, investment companies, but I anticipate—at least, I believe—that they will go along with the title as it is drawn.

Senator TOWNSEND. You speak of your limitations under this authority. In what way are you limited?

Mr. SCHENKER. Now, Senator, Title 2 begins——

Senator TOWNSEND. I mean in your study. The language here is very broad:

> The commission is authorized and directed to make a study of the functions and activities of investment trusts and investment companies, the corporate structures, and investment policies of such trusts and companies, the influence exerted by such trusts and companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies, and to report the results of its study and its recommendations to the Congress on or before January 4, 1937.

Mr. SCHENKER. You notice that language says we are authorized to make a study of investment trusts and investment companies, which is different from investment counselors, because investment trusts and investment companies sell their securities to the public, and an investment counselor is a partner or individual who has a professional relationship with a client. He is not part of the investment trust or investment company except as he may give advice to an investment company or investment trust.

We made a detailed study of the investment companies. We expect in a few days to tell you what we found. But with respect to the investment counselors, we felt that our only jurisdiction was to get some information with respect to those investment counselors who are associated with investment companies.

The jurisdiction to investigate investment companies was broad. The only thing we could do with respect to investment counselors was to find out what influence they exerted on investment companies and we have done that.

Senator TOWNSEND. Well, what, if anything, has held up the report that should have been made in 1937 until 1939?

Mr. SCHENKER. I am glad to answer that question, Senator. The Public Utility Holding Company Act was passed, if my memory serves me right, in July of 1935. The 1933 act had been passed, the 1934 act had been passed, and the 1935 act had been passed, and in connection with every one of these acts, Senator, there were certain organization problems.

We tried to get started as fast as we could, and my recollection is that we started holding conferences with the industry in connection with the preparation of a questionnaire to be sent to the industry sometime in November or December of 1935.

Now, when we come to analyze this industry, Senator, I thought, as probably you do, an investment trust is a simple organization run by people who are expert managers. You turn your money over to these organizations and they manage it. Apparently, therefore, it looks like quite a simple matter. However, when we came to study the industry we found that the situation was not that at all.

In the first place, you have investment companies which give their management untrammeled discretion with respect to the investments they can make. Then you have the so-called fixed trusts, which were devices whereby management was completely eliminated. You had the so-called open-end companies, and that is the Boston type of company, which gives the stockholder the right to redeem his share at asset value. Then you have the type which sells a face-amount contract, which is nothing more than a contract, a promissory note to pay a specified sum, which you purchase on the installment plan at $10 a month. Not only did you have these broad classes, but in each type you had a variety of types. In connection with the management companies, some companies say, "We are management companies but we limit our discretion with respect to special types of securities like insurance stocks."

That is not so bad; complications are all right, but the fact is that during the very course of our investigation the basic underlying nature of the industry was changing. Up to the time we started our investigation most of these companies were closed-end companies which had raised their funds in 1929. Their securities were selling at a discount, and in order to overcome that situation new types of companies were being organized and emphasis was being placed on new type of investment companies.

While this investigation was going on there suddenly appeared a type of situation like this: Investment-trust certificates were being sold to the public on the installment plan, and that means that they were getting down to the lowest stratum of our economic population. As we will show, that development took place during the very course of the investigation. So we had a situation where servant girls, miners, policemen, letter carriers—we will have a full list of these occupations—were being sold equity stocks under the guise that they were investing in a savings plan. That problem was almost equal in scope to the one which existed before. These Boston companies which had previously been in existence grew tremendously in that period and they presented peculiar problems. Their problems mostly related to the distribution aspect, because in an open-end company the stockholder can say, "Here is my certificate. Give me the asset value of my certificate."

The assets of open-end companies rose to $600,000,000 in this period.

Senator, you were not here when Judge Healy made this statement—and that is one of the things that in my opinion makes it essential that this legislation be passed—that at the very time we were conducting this investigation some of the most outrageous abuses and wrongs were being perpetrated. I thought every day, "Thank God, I am through with hearings," and then I would get a telephone call. Somebody was looting another investment trust by some other method, and we had to start all over again.

The fact is that one of the most outrageous things, and you will hear all about it tomorrow, took place in the latter part of 1937. Here I was in the midst of writing my report. Through some fortuitous circumstance we got the information about this looting and I had to undertake an investigation of the whole Continental Securities case, where they cleaned out the First Income Trading Corporation out in Detroit, Mich. They cleaned out the Continental Securities Co. Then they got into the Bonding Share Co., the Reynolds Investing Co., the Burco Trading Corporation, and the Insuranshares of Delaware Corporation.

Senator TOWNSEND. Do you not think, if that happened in 1937, Congress was entitled to a report earlier than this on that matter?

Mr. SCHENKER. Maybe I am to blame a little for that. I have listened to statisticians a little too much, and if you ever had anything to do with a statistician you will know the meticulous care with which they want to prepare the information. The fact of the matter is that we have a thousand pages of statistics, and Prof. E. B. Wilson, of Harvard University, said that it is one of the most thorough jobs he has ever seen.

The fact is that we made progress reports to the Congress as we went along and we started sending out our reports on June 10, 1938. That is in addition to the summary reports that were sent up.

Then, Senator, no one is more mindful than I am of the technical aspects of this business. I just did not want to go haywire and I just wanted to make sure, as did the Commission, that we understood every aspect of this business, that we understood every aspect of every subdivision of this business. We wanted to do a most competent, objective job, and I think the consensus of opinion, even among the industry, is that we did that. We may have taken a little longer than we should have.

Senator TAFT. How big a force has been used on the work?

Mr. SCHENKER. We started, of course, in the first instance, with a staff of about 45, which included people who had to go out in the field. Now, you take one of the biggest system investment companies, the Founders companies, to which $500,000,000 of the people's money was contributed by 1929 and in which the stockholders lost $376,000,000. There was nobody there to help us make a study of these companies. They literally did this, Senator——

Senator TAFT. I am not criticizing you. I was just trying to find out how many worked on it.

Senator WAGNER. You started to say "They literally did this." You did not finish.

Mr. SCHENKER. They took two roomfuls of books and dropped them in Bill Spratt's lap.