Paragraph (4) is the most serious and devastating of the provisions in this section in that it would appear to segregate management and distribution of open-end companies.

I was somewhat surprised to find such a provision in the bill after Judge Healy's opening remarks on the matter of segregation as follows [reading]:

nor does the bill require the segregation of * * * distributors from the management of investment companies.

The language of the bill states that it shall be unlawful for the manager of an open-end management company to serve or act as principal underwriter—which is another term for distributor—thereof. I cannot reconcile this provision with Judge Healy's remarks, and while I have criticized the bill as being vague and indefinite in many respects, I am afraid that it is extremely clear and definite in this respect.

While there are certain important and successful investment trusts where a formal segregation of sales and management prevail, the overwhelming practice in the industry is a combination of these functions in the same group. This is not a new situation, but has existed over many years. A change, therefore, would involve the disintegration of the prevailing method, which is widely and well established, and could not be accomplished without a serious upset in the management and distribution of the great majority of trusts, with possible undesirable consequences for thousands of shareholders.

I am referring there, of course, to so-called open-end trusts.

A change of so serious a nature would not seem justified in the absence of disclosure during the thorough and extensive investigation made by the S. E. C. staff of differences in practice or performance which indicated definitely that segregation of the functions had produced better results than combination, or avoided evils which experience showed to be inherent in combination of the functions of management and distribution. Such evidence, however, is conspicuously lacking both in the reports of the S. E. C. and in other statistical records of the segregated versus the nonsegregated functions.

The following quotation from its report sets forth the conclusion arrived at on this point by the S. E. C. [reading]:

The sponsors of open-end companies were classified either as sponsors primarily engaged in the distribution of securities or as sponsors primarily engaged in the management of investment funds. This classification was motivated by the desire to ascertain the effect upon performance, if any, of participation by management in the business of security distribution. The classification is admittedly broad, but the present data permit of no further gradations. In no year is there a significant difference among the means. In 3 years, the performance relative of companies whose sponsors were "distributors" was higher: In 3 years "managers of funds" performed better. It can at least be said that the available data do not afford a statistical basis for differentiating between the performance records achieved by these two classes of managers. (Report of the Securities and Exchange Commission pursuant to sec. 30 of the Public Uility Holding Company Act of 1935, pt. 2, vol. IV, ch. VI, p. 80.)

That there is no basis for differentiating between performance records finds additional support in a comparison made by Barron's in its January 29, 1940, issue of the performance of 36 leading open-end investment trusts. Classifying the 36 companies according to the type of sponsor; that is, primarily "distributors" or primarily "managers," and averaging by such classifications the performance figures given, we find the following results:

Average annual performance, classified by type of sponsorship, 1936–39

	1936		1937		1938		1939	
	Number	Average	Number	Average	Number	Average	Number	Average
Type of sponsorship:								
Distributors	24	+31.1	25	−36.4	26	+22.2	29	−3.1
Managers of funds	6	+32.1	6	−29.3	6	+19.2	7	−.8
All companies	30	+31.3	31	−35.0	32	+21.1	36	−2.7

Again, using Barron's study as the basis for a slightly different method of approach, we find that if the companies included are listed in order of performance in each of the past 3 years, the results are as follows:

In 1937, of the first 11 companies 7 represent nonsegregated and 4 segregated operation.

In 1938, of the first 10, 8 represented nonsegregated and 1 segregated operation, 1 of the 10 not being included in either group due to difficulty of immediate determination of character of operation.

In 1939, of the first 11, 8 represent nonsegregated and 2 segregated operation, 1 of the 11 not being included in either group for the reason noted above.

That is hardly a convincing case that segregated operations produce better results than nonsegregated ones.

Senator HUGHES. Can you illustrate—because you are more familiar than I am or than other members of the committee who will read the record—what you mean by segregation of management and distribution?

Mr. EBERSTADT. Gladly, Senator. Perhaps I can clarify that. The open-end investment trust is a type which continues to sell shares. It requires, therefore, the performance of two functions. One is the management of the portfolio, which is generally done pursuant to a contract approved by the board of directors and/or the stockholders. The people who are the contracting parties also are the directors on one side and the managers on the other. The other function is the continued sale of the shares, which is done generally pursuant to a contract between the directors and a so-called underwriter or distributor. The prevailing practice in the business is to have the functions of management and distribution confined in the hands of one group. That is not without exception. There are a great many exceptions. But the overwhelming prevailing practice in the industry is that the same groups enjoy contractual relations for management and for distribution.

The bill, as I understand it, purports to forbid the same group from occupying the dual relationship of management and distribution; and I have just finished reference to the S. E. C.'s report indicating that they found no difference in the performance, or at least had not at the time the report was made; and I also analyzed some statistical information published as late as January of this year. I think I can say without fear of contradiction by anybody that there is no definite difference in performance between those trusts where management and distribution are separate and those trusts, which is the overwhelming practice in the business, where management and distribution are in the hands of one group.

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Senator HUGHES. Thank you.

Mr. EBERSTADT. The only possible conclusion to be drawn from the foregoing would appear to be that there is no evidence in the record of significantly superior performance on the part of the segregated units.

Thus, both the study of this Commission and the record of performance are such as to cast serious doubt upon the wisdom and necessity for this provision.

It would be ordinarily expected, too, that the underlying reasons for the proposed segregation would be set forth in the reports of this Commission, with accompanying citations of cases in wh ch nonsegregation had led to unhappy results, but we find nothing in these reports to indicate that this requirement of segregation represents a considered conclusion by the study group, or is based on any persuasive exposition of principle, or is called for by any abuses inherent in either the theory or accepted practice of open-end mutual-investment companies.

Whether management and distribution are in the same or separate hands, there is so close an affinity of purpose and function as to render a legal segregation merely a matter of form. Whether separate or apart, both are presumably interested, from the financial point of view, in the successful operation of the trust. Both are equally interested in the sound and healthy growth of the trust. There is a complete identity of fundamental motive and objective in management and distribution.

It is not to be assumed that by segregation the interest of the distributor in the make-up of the portfolio would be lessened, or by such segregation that the manager would be insensitive to sales peformance.

Regardless of formal and legal separation of functions, the distributor and manager remain engaged in one undertaking, which cannot be successful in either branch without successful performance on the part of both; the prestige of both are pledged to the one objective of a well managed unit; the compensation of both flows from the successful carrying out by each of his respective functions; and the motives of both, whether or not formally segregated, are not only not several and antagonistic, but are necessarily identical.

Whether the functions of management and distribution are segregated or combined, we submit that if the investment trust has an independent majority of the board of directors, such a board accomplishes an effective check on any possible conflicts of interest between management and distribution, and that this is not only the simplest and best solution but that it is actually the only true and complete solution. In principle this provision is aimed at curing an evil which does not exist by a method which would not cure it if it did.

I think it has already been pointed out to the committee that during the early years of trust management the normal and reasonable management fees frequently fail to defray the cost of good management.

In the event of segregation, the management of a trust must look forward to a considerable period of loss before recouping its costs, a risk which would seem to be hardly justified, particularly in the light of existing obstacles to the formation of new trusts, as well as certain other provisions under consideration, which must necessarily have a further serious deterring effect on new trust formation.

If, in addition to the losses of good management in the early stages, there is to be added the investment, running into thousands of dollars, necessary to defray the costs of essential preliminary studies and investigations, registration under the Securities Act of 1933, compliance with "blue-sky laws," and so forth, such segregation would appear to constitute another effective deterrent to the formation of new trusts.

Speaking from practical experience, we know that there is no essential, nor, as far as we have been able to discover, apparent conflict between management and distribution. Yet, if the two functions had been required to be segregated in July 1938, it is very probable that chemical fund would not have been formed.

This is not for any one reason, but rather springs from a combination of circumstances related to the particular nature of an investment trust. The economics of the situation would undoubtedly have been an important, perhaps almost a sufficient reason—for no one likes to make a substantial investment in time and organization expenses, to face a period of operating losses, and to assume many risks against the possibility of a return that is not compensatory. Of almost equal importance, however, would have been the unwillingness to entrust to another either management or distribution when the successful performance of both was so obviously necessary for the success of either.

The S. E. C. has created an evil that does not exist, and has set about to cure it in a way that would not cure it if it did exist.

To sum up, in view of the fact that neither in the studies of the S. E. C., nor in independent statistical information, have we found significant evidence of superior performance through segregation of management and distribution, or of a tendency to abuses when these two functions are combined; furthermore, because of the prevailing practice in the industry; because of the disruption, expense, and possible loss which would result from compelling segregation; because of the failure of segregation to meet the point at which segregation is apparently aimed, which can be more fully and better met by an independent board of directors; because of the tendency of compulsory segregation to result in a monopoly by existing large trusts; and for the other reasons indicated above, we strongly urge the committee to eliminate this provision requiring segregation of management and distribution.

Section 10 (e) prohibits any director or officer of a registered investment company from serving or acting as director or officer of any portfolio company, if such registered company owns less than 5 percent of the outstanding voting securities or such director or officer is an investment banker or broker. I cannot understand the magic of less than 5 percent. Inasmuch as diversified investment companies are restricted to 5 percent, it seems to me that no director of a diversified investment company can be a director of a portfolio company under the bill as drawn. I can see how the bill might provide that no director of an investment company could be a director of a portfolio company, but I cannot see why it is iniquitous to be a director if your company owns less than 5 percent but that the iniquity is removed as soon as you own 5.1 percent. I think the situation is stated exactly in reverse.

Going back to fundamentals, that an investment company should have a majority of independent directors, none of whom are affiliated with the manager or adviser or with each other, I can see no harm in a director also being a director of a portfolio company, whether or not he be an investment banker, and I can see a great many benefits in the way of information, and so forth, that might flow therefrom.

Section 10 (f) provides that no director of an investment company shall be affiliated with a firm which serves or acts as principal underwriter for an issue of which such registered company owns more than one-half of 1 percent of any class of outstanding securities. 10 (g) which is related to it, prohibits the purchase by an investment company of any security, the principal underwriter of which is a director, officer, or manager, excepting where such company has itself been underwriter, or after the expiration of 1 year from the offering.

If this provision is to be taken literally, it is the end of open-end companies, because it prohibits the repurchase by an open-end company of the shares which it has issued. But I do not think that was intended, and I will disregard that criticism.

I agree with 10 (g) and feel that it is simple, clear, and goes the whole route and gives every protection to the trust. But I very much disagree with 10 (f). There again we have a magic figure—this time one-half of 1 percent. One-half percent of Standard Oil Co. in dollars and in influence is quite a different thing from 5 percent of a smaller company.

I regard 10 (f) as very definitely discriminating against the inclusion of securities of thoroughly sound but smaller companies in the investment portfolio. I can see no possible harm likely to result to an investment company from having its manager or underwriter also be principal underwriter of an issue of securities of which the trust owns, say, not over 5 percent. I can see very great harm in this prohibition as it stands. Let's take, for example, our consideration of forming a speculative company in the chemical field. Assume that through investments of this company a business was brought along to the point where it needed substantial additional capital, more, if you will, than the trust could or should supply. Could anything be more natural or logical or beneficial to all concerned than that we should underwrite for public offering an issue of the securities in question?

Please bear in mind throughout my remarks that I am taking a situation with an independent board of directors, a situation where the management contract has been approved by the stockholders as required by this bill and, so far as I am concerned, a situation where the distributing contract also has been approved by the stockholders, which are natural and not artificial protective measures.

If, as we have recommended, the trust has a majority of directors independent of manager, distributor, and each other, bearing in mind that a diversified trust cannot have more than 5 percent of its assets in any single situation, I can see nothing protective from the point of view of the trust in this section. It is apparently aimed at preventing any investment banker related to the trust from participating, as a practical matter, in the underwriting of securities which are held in the trust. I agree that the relationship of an investment banker to a trust should not be exploited, but on the other hand, it seems to me grossly unfair to penalize such a relationship under circumstances where it could not be harmful to the trust itself.

This is particularly true in the light of the complete and proper protection to the trust against dumping which is provided by section 10 (g), with which, as I have already stated, I fully agree.

With respect to (h), I have nothing to say, as obviously what the bill prohibits directly is illegal by indirection.

I am not qualified to talk on section (i) as we have no familiarity with that type of situation, but I think my foregoing remarks apply generally to that situation, which is a special type of trust.

Turning now to section 11, headed "Recurrent Promotion of Investment Companies":

Section 11 would effectively prevent the formation of a new trust by an existing and presumably experienced sponsor regardless of the purpose or function of this trust, or its relation to an existing trust to which the sponsor is related.

I am not taking up the problems that may arise from sponsorship of two trusts identical in nature. These are of a special sort and have been, or will be, discussed by others. We are concerned, however, with the situation of the sponsor of an existing trust who may be particularly qualified for and desirous of forming a new trust in no way competitive with the present trust and whose functions and purposes are quite different.

There is at present an obvious dearth of investment banking or underwriting capital. There is practically a complete lack of speculative or risk capital. There would seem to be no reason for embodying in the bill restrictions which would prevent the formation of a trust permitted to underwrite or invest in companies, too young or too small to attract public capital. Obviously most of the present open-end investment trusts may not or could not, perhaps should not, participate in this category of business, so that the entrance into this field by new trusts would, for many reasons, require a different set-up especially designed for the purpose.

The fact of the existence under like sponsorship of an established investment trust, particularly where its record is creditable to the sponsors, should not be permitted to stand in the way of the formation by them of a new nonconflicting trust. Again I qualify my statements on the assumption of an outside independent unaffiliated majority of directors. The same is true perhaps in an even greater measure with respect to a trust organized for the purpose of supplying capital to new or young ventures. The importance of this to our economy particularly at the present time would hardly seem to need stressing.

There is less necessity for this restriction, and particularly for a time limitation of 5 years, today than heretofore. The bill contains a provision for a minimum investment of $100,000. This will of itself exclude a great many possible, and all frivolous, trusts. Furthermore, the expense of setting up a trust, in addition to the investment, runs into many thousands of dollars. The time and effort necessary to comply with the requirements of the 1933 act, the "blue sky" laws of the various States, and the technical and contract papers now necessary, themselves offer an obstacle of time and expense which is a new and effective prohibition to mass production of trusts.

Most of the testimony furnished to the committee by the S. E. C. has consisted of horror stories of offenses committed by thieves or embezzlers, although practically every S. E. C. witness has spoken highly of the great majority of the individuals in the business. I do not minimize the seriousness of these wrongdoings, but it hardly seems reasonable to legislate and regulate on the basis of these scandal stories.

And so I strongly urge that instead of adding to the present mountain of laws, rules, regulations, releases, and bulletins which constitute ever-increasing barriers to the free flow of capital, without departing one iota from the strictest application of the doctrine of "truth and fair dealing in securities," you treat the subject of investment companies as part of an examination of the general field of capital investment, which well merits your constructive attention on the basis of the 7 years' experience which we have had under existing laws and regulations. Most of these acts can and should be preserved, but there is a massive barnacle growth of incidental, irrelevant, burdensome, dilatory, and expensive detail which must be stricken down if the free flow of capital is to be restored.

I thank you.

Senator HUGHES. Did you state where your business is located?

Mr. EBERSTADT. New York City, sir.

Senator HUGHES. Have you something more that you would like to say?

Mr. EBERSTADT. I just had a note handed to me and, with your permission, I will read it.

Senator HUGHES. Very well.

Mr. EBERSTADT (after reading note referred to). I have nothing further, sir.

Senator HUGHES (presiding). Mr. Roger Amory will be the next witness, I understand.

STATEMENT OF ROGER AMORY, PRIVATE TRUSTEE AND DIRECTOR OF VARIOUS COMPANIES, BOSTON, MASS.

Mr. AMORY. My name is Roger Amory. My address is 19 Congress Street, Boston, Mass. My occupation is that of private trustee.

In the very brief statement which I am about to present I am trying to make five different points. First, I want to say that I am an investor, and I am appearing here in the capacity of investor and in that capacity alone. I want to point out the type of information that the investor should have and be able to rely on as to the funda mentals of it. I will speak then of the nature of the abuses of investment trusts, as I see them, and the suggested remedies for such abuses, and then state why I am opposed to S. 3580.

First, in order to show my position as an investor, I serve as executor, trustee, guardian, financial agent, and family adviser, which includes advice on financial matters. I serve as officer or director of real estate and personal property investment trusts, and as a director or member of investment committees, trust committees, and executive committees of various banks and of an insurance company. I have been in the business of investing other people's money for over 28 years. It is my sole business.

As trustee under wills and indentures or as guardian, I have a voice in the investment of approximately $30,000,000.

As agent, family adviser, or treasurer of a charitable organization, I have a voice in the investment of approximately $12,800,000.

As trustee or director of real estate trusts, I have a voice in the investment of approximtely $4,600,000.

It might be said that this is the major part of my business. However, I do not distinguish in my mind or in my efforts between the fiduciary treatment of investment problems in any of the foregoing capacities and in any of the following ones:

As trustee, director or member of the advisory board of investment trusts, I have a voice in the investment of approximately $141,700,000.

As director or member of investment or trust committees of banks and of an insurance company, I have a voice in the investment of approximately $497,000,000.

In other words, I have a voice in the investment of approximately $686,100,000.

This is a very large total, but I want to point out that of it I personally control the investment of less than one-tenth of 1 percent, and this one-tenth of 1 percent represents almost entirely funds of my own family. All the rest is subject to the joint control of co-trustees and co-members of the boards and committees on which I serve, and here, of course, I have only a voice as part of the group in controlling the investment.

I give these figures to show that I am engaged primarily in making investments.

When judging the advisability of investing in a security, I must consider.

1. The ability, integrity and experience of the officers and directors of the company which issues the securities.

2. The financial condition and earning record of the company, its financial structure, and the nature of the security in question.

3. The nature of the business.

4. The extent of the interest, financial and otherwise, of the officers and directors in the company.

I believe that investment trusts perform a legitimate function in the economic life of the country. I believe that securities of investment trusts are useful and desirable mediums of investment for small fiduciary accounts and for individuals of small means desiring diversification of risk.

I believe that the abuses of investment trusts have arisen—

1. From abuse of the corporate structure itself which makes it possible for officers and directors to avoid fiduciary responsibility; which permits the superimposing of one company on another; which allows the directors to act without any financial risk on their part, and, further, allows them to sell out their stewardship.

2. From failure of the officers and directors charged with the care and management of the investors' money to conform to the long-recognized rules of fiduciary conduct.

3. From failure by the management of investment trusts to give accurate and adequate information to the stockholders and prospective stockholders.

It seems evident that some form of legislation is necessary in the interests of the public to prevent these abuses. The States have power to cope with these problems and many of them are making efforts to do so; but if Congress considers that Federal legislation is necessary and within its constitutional authority, then I believe that such legislation should be along the following lines. The philosophy back of these suggestions which I am about to make is—

> that it is not possible to make men honest by either legislation or supervision, or by both, but that it is possible to make unethical procedure illegal.

A. All investment companies, whether or not heretofore registered, should be required to register with the Securities and Exchange Commission and to furnish to the Commission full information as to the nature of their business and as to the qualifications of the management and other persons connected with the business.

B. To eliminate the abuses outlined above the legislation should provide—

(*a*) that the directors and others participating in the management of a company shall assume the same responsibility and use the same degree of care and skill which an ordinary prudent man would use under the circumstances in the conduct of his own affairs and that no contractual waiver of that responsibility should be permitted;

(*b*) that no investment trust shall be allowed to purchase shares in another investment trust except on specific authority given by the stockholders for each individual purchase;

(*c*) that the directors shall own and hold unhypothecated qualifying shares in amounts at least as great as those required of directors of banks and that certificates to that effect shall be filed annually with the Commission;

(*d*) that in the case of a company having directors elected by the stockholders, there shall not be in office at any time directors who have not been elected by the stockholders, who in number constitute more than one-third of the directors then in office, and that in the case of a company where the directors are not elected by the stockholders that no more than one-third of the directors be changed within a 12-month period without approval of the stockholders.

C. To eliminate the abuses outlined above under 2 the legislation should provide:

(*a*) that no financial transaction between an investment company and any of its officers or directors shall be entered into unless specifically authorized by the stockholders and a full disclosure of all profits arising therefrom is made in the periodic reports to the stockholders;

(*b*) that every management and distribution contract made with an investment company shall be terminable by the investment company at the will of its board of directors whenever a majority of such directors shall not have been directors at the time the contract was made.

D. To eliminate the abuses outlined above under 3 the legislation should provide:

(*a*) that investment companies shall be required to give to their stockholders and make available to prospective purchasers of their stock adequate financial statements and information as to the nature of their business and the qualifications of their management. The periodic statements furnished to stockholders should contain accurate statements as to the nature of the business, the policies of the management, the arrangements made for custody of the assets, and the affiliations of the officers and directors in each company in which the investment company owns securities or with which it has any contract. These periodic statements shall be in such form as seems best to the management.

I will stop there to make the point that in my opinion the directors, holding, as they do, a fiduciary position to the stockholders, should put the reports in form so that the stockholders will understand them.