incorporated within that State, with which, of course, you are familiar. You are also familiar with the fact that the bill as it now stands does not include such an exemption, but differs from the Securities Act. What is your answer to that?

Mr. SCHENKER. We received a similar letter, Mr. Cole. Mr. Hollands has worked on that problem, and he will expound a little on that question.

Mr. COLE. Yes. I had a letter yesterday which I turned over to you, and this telegram has come in today discussing the same thing.

Mr. HOLLANDS. Mr. Cole, Judge Healy got an identical telegram, I believe, last night from these people, and we prepared a memorandum on the points last night, because it is the type of a subject that could be better dealt with with a memorandum than by oral presentation.

That memorandum is being retyped, and I understand is on its way here from the office now, and should be here in the next 10 minutes, perhaps. (This memorandum is inserted at the end of testimony of June 14, 1940.)

Mr. COLE. All right.

Mr. SCHENKER. Section 12 merely states that hereafter investment companies cannot trade on margins or participate in joint trading accounts or effect short sales in violation of any rules or regulations that the Commission may formulate. These matters are at present of no particular moment, and any problems that may be created in the future, we can deal with by rules and regulations.

The next subdivision provides that an open-end company cannot be its own distributor except in accordance with rules and regulations. That protects the open-end company against excessive sales, promotion expenses, and so forth.

Subsection (c) permits a diversified company to engage in underwriting provided these commitments do not exceed 25 percent of its total assets.

Subsection (d) is an important provision. This provision will stop what we call pyramiding of one investment company upon another investment company. That situation was not unusual in the past. A Investment Company would buy a controlling interest in B Investment Company, which in turn would buy a controlling interest in C Investment Company. As a consequence you had pyramiding of investment companies, systems with complicated capital structures with all of the difficulties of pyramided systems. This subsection provides, that hereafter one investment company cannot buy the securities of another investment company in an amount to exceed 3 percent of its outstanding voting securities.

Three percent was fixed, because you may get situations where one investment company may think that the securities of another investment company are a good buy and it was not thought advisable to freeze that type of purchase. Three percent of the outstanding voting securities of a company has no significance, so far as the control is concerned, and yet would permit one investment company to purchase the securities of another investment company. There may be some investment companies, for instance, which think that aviation stock may be a good buy, but instead of going out and buying diversified blocks of aviation company stocks, the company may buy the securities of some investment companies which specialize in aviation stocks.

In that way an investment company can get a cross-section of all aviation stock by buying some shares of stock of an aviation investment company. The bill permits investment companies to acquire securities of specialized investment companies to the extent of 5 percent of such company's outstanding voting securities. Suppose you have this situation: A Investment Company owns 25 percent or more of B Investment Company then A Investment Company really controls B Investment Company. It does not make sense to say that A Investment Company can control B Investment Company, but A Investment Company cannot buy any more of the stock of B Investment Company. You have got to permit A Investment Company to acquire additional stock because A Investment Company may want to get sufficient securities to work out a reorganization and collapse those two companies into one company. If A Investment Company already controls the B Investment Company, then there is no difficulty in letting A Investment Company increase the size of it block in B Investment Company.

This bill prevents in the future one investment company from buying control of another investment company and creating these complicated pyramided structures.

The bill contains a similar provision with respect to companies, investment companies acquiring controlling blocks of stock of insurance companies. That relationship may have very undesirable features. An investment company cannot buy more than 10 percent of the outstanding stock of an insurance company. However there may be insurance companies which may need finances, and in that situation the investment company may make application to the Commission for permission to buy into that insurance company to try to salvage it.

And, on page 55, we have made the provision for a type of company which both the industry and we feel may be one of the most salutary provisions in this bill.

Mr. REECE. To what extent have the companies engaged in the activity referred to in this subsection, heretofore?

Mr. SCHENKER. One investment company buying into another investment company?

Mr. REECE. No.

Mr. SCHENKER. Venture or risk capital transactions?

Mr. REECE. Yes.

Mr. SCHENKER. We have made a study of that subject and we found it to be negligible, absolutely negligible.

What this bill attempts to do is this: In the past, investment companies—and that is particularly true of open-end companies where the certificate holder can compel the company to buy back his certificate at its asset value at any time, the companies had to be in liquid condition all of the time, because they cannot anticipate the extent of redemption demands they will have to meet. So, so far as the open-end companies are concerned, they have their funds invested almost entirely in blue-chip stocks or liquid securities. They have to be in that position.

Now, with respect to the closed-end companies, where the stockholder does not have a right of redemption, our analysis indicates that they have not invested in venture situations, although recently Atlas Corporation, the Chicago Corporation, and the Lehman Cor-

poration have been doing some of that type of investing. We have been trying to encourage that activity.

Mr. REECE. Have the companies indicated that they might be able to do this?

Mr. SCHENKER. This provision has been inserted as a result of our studies and our talks with investment company representatives. Here you have this tremendous pool of liquid capital that has not been effectively diverted into these channels of financing industry. This provision in this bill is to encourage this flow of capital in these channels.

Mr. REECE. I think that is a good proposition and I hope that the companies will be in a position to accomplish what you have in mind in putting it in.

Mr. SCHENKER. Now, of course, I cannot make any promises; but I have every hope from my discussions and Judge Healy's discussions with these representatives, unless it has been terrifically complicated by this war situation—and I think that that will act as a stimulus rather than an impediment—I have every hope that immediately after the passage of this bill the larger investment companies are going to get together and create a substantial pool of venture capital by participating in the type of company for which this bill provides.

Mr. REECE. If so, I think all of your labors will have been justified.

Mr. SCHENKER. We feel that way and the encouraging thing is that some of the open-end companies who never went into this type of transaction have manifested a desire to participate in that type of company.

After all $100,000,000 in one venture capital type of company is more capital than the average investment banker has for that type of activity. Here you have this tremendous liquid pool and when we have the necessary regulation in which people can have a sense of confidence that they can go into this type of company and at least not be subject to some of the more outrageous abuses of the past, I think that you will get a stimulation for forming this type of company. Furthermore, with this type of company as a nucleus, and if it works, then the Treasury can see whether it cannot make some accommodation with respect to taxes of that type of company.

At the present time the problem gets too complicated from the tax angle. This type of company I think may—I am not saying that it is a panacea—but I think it will possibly break the ice and loans might be made to small companies. In the first place investment companies are equipped for this type of activity. They have the statistical staff, the research staff; they can study the company; and they have been trained for such transactions. The Lehman Corporation has started to do it. The Chicago Corporation has started to do it, and the Atlas Corporation has started doing it in a small way, as has the Phoenix Securities Corporation.

Now, this bill will permit a diversified investment company whose general business is investing in blue chips to at least take a part of its funds and make it available as venture capital.

Mr. REECE. Has any study or thought been given to the possibilities of getting the Treasury to give some tax relief in certain instances?

Mr. SCHENKER. Well, the whole tax problem in connection with the investment company is difficult and a little acute. Mr. Jaretzki,

who represents the closed-end company wants to say a few words about this whole problem of taxation.

Mr. REECE. I am very much interested.

Mr. COLE. At this point?

Mr. JARETZKI. If you do not mind, as long as you have raised the point, the tax situation is something very difficult. The investment companies have felt for a long time that they required special tax treatment, because in the main investment companies are a conduit through which the small investor receives his income, namely interest and dividends from the portfolio companies. This income is thus subjected to double taxation. This is a burden which the investment companies cannot support for long. And then there is the situation in respect to encouraging venture capital, that Congressman Reece referred to.

Now, several years ago Congress recognized this situation and made an exception in favor of the open-end companies. The open-end companies, if they comply with certain conditions are free, virtually free, from taxation. The income merely flows through those companies into the hands of the stockholders. The stockholders are taxed, and not the company.

We of the closed-end companies have earnestly urged to the Treasury, and will continue to do so, that the closed-end companies need tax relief just as well as the open-end companies. Their problems are different and possibly the type of tax relief will have to be different; but we are very hopeful that with the passage of this bill and with these companies placed under regulation the Treasury will see fit to go into this problem.

The Senate committee in its report called attention to this tax problem and recognized that there was the necessity of relief.

Mr. REECE. Just speaking for myself, I hope that those possibilities may be explored by the Treasury Department or any other Government agency which may have anything to do with it.

Mr. JARETZKI. We would respectfully urge, Mr. Reece, that your committee express itself in some such way in your report, if you do report this bill, because we think it very important to the industry.

Mr. SCHENKER. May I continue?

Mr. COLE. Yes.

Mr. SCHENKER. Section 13 merely provides that once you have told your stockholders what type of company you are, the type of activity that you are going to engage in, you cannot, overnight, change the fundamental nature of your business without telling your stockholders, and getting their consent.

Mr. BOREN. One question there. In requiring a majority of the outstanding voting securities, what would be the situation there with reference to voting those securities by proxy or some indirect method?

Mr. SCHENKER. Well, we have a proxy provision in this bill which is the same as in the 1934 act, so that there would have to be complete disclosure and so forth. We protect that situation.

Mr. BOREN. I have read that provision. I am just wondering if it will work in a situation of this kind.

Mr. SCHENKER. You see, this bill is practically a reenactment practically verbatim, of the provisions of the 1934 act. Under the 1934 act we formulated rules and regulations with respect to proxies which have worked, and by incorporating the same language we intend

that the committee really affirm the practices and regulations that have been formulated under the 1934 act. They have been successful.

Mr. BOREN. I do not propose to know enough about it to lay down a formula on it; but I am myself convinced that the proxy system needs a lot of changes. We can pass this question for the time being.

Mr. SCHENKER. Section 14 deals with the size of the company.

Mr. BOREN. That is one that I wanted to discuss.

You go down into the States with this bill and regulate every little investment company. As I read the bill the smallest loan, real estate, or other type of company which could be organized on a security basis could be regulated here and yet you arbitrarily set up the $100,000 figure. I just want you to clearly explain to me why $50,000 or $100,000 or $200,000 would make any difference at all in the financial solidarity of a beginning firm. It seems to me a $50,000 firm with a much smaller operating field will be sounder than a $100,000 firm with an operating field four times as large.

Mr. SCHENKER. There is a great deal in what you say, for it is not an easy problem. We have given a great deal of attention to that question. For instance, Alfred Cook, who represents the trustee in the Continental Securities Corporation reorganization, thought that $100,000 was too little. He says, "I cannot visualize an investment company with less than $250,000 doing a job for investors."

Mr. BOREN. Where did he live?

Mr. SCHENKER. He is a New York attorney who is trustee for Arthur Ballentine, trustee, for Continental Securities Corporation.

Now we canvassed this problem very carefully with the industry. The industry felt that $100,000 was too little. They continually urged a larger amount, because they did not think $100,000 was sufficient.

Mr. BOREN. Why not put a percentage provision of some character in? Is it not practical to arrive at a sliding scale on that instead of setting an arbitrary basis?

Mr. SCHENKER. If you will just give me one second.

Mr. BOREN. Yes.

Mr. SCHENKER. I think you have to distinguish this situation from a minimum requirement in the face-amount certificate company. This is the type of investment company which goes out and sells securities to the public and says, "You turn over your money to me. I am an expert. I know how to manage your money better than you. You turn over your cash to me."

Now, this $100,000 limitation serves two purposes, in our opinion. It takes every fly-by-night out of the picture. To organize an investment company today you can have your office in your hat. You can get out your circulars, pay a lawyer a small fee for drawing up your organization documents, file a simple registration with the Securities and Exchange Commission, and go out and get a bunch of salesmen and start peddling investment-company securities.

Now, everybody, regardless of who he is, or what his background is, or what his financial responsibility is, can organize these companies helter-skelter. This provision will have the salutary effect, in our opinion of not letting anybody who has just got an idea of forming an investment company, say, "Let's go see a lawyer and let him draw up our papers, and let's start selling securities. That is point No. 1.

Point No. 2, the promoter ought to at least have a little money to get started, to buy at least a couple of statistical service manuels and at least be able to obtain some statistical analysis of securities. He has to have an office. He has to have a couple of analysts, or else you are turning your money over to a fellow who is merely in a tipster with some fancy ideas as to how to make money fast in the stock market. This provision assures some element of responsibility on promoters.

What this provision really states is: You ought to have initially a pool of at least $100,000 before you go around asking the public to turn over their money to you for your management. Also you ought to have a pool of money with which you can at least get some research facilities to make adequate analysis of the securities that you intend to buy.

Now, I admit that $100,000 is an arbitrary figure. It could just as well be $75,000 or $125,000.

But, we felt from our 4 years' study, from talking to everybody in the industry from the experience of the small companies that if a promoter cannot get people to back him in the first instance in an amount of $100,000, he should not be permitted to go throughout the entire country and start taking the savings of the people.

Mr. BOREN. Have you ever talked to those people who tried to raise $100,000 in a small midwestern community?

Mr. SCHENKER. No, sir.

Mr. BOREN. I have in mind a company called the Sneed Investment Co., at Bristow, in my State, a little town of about 9,000 people. It has been in business for 20 or 30 years. I do not know what capitalization it has, but I imagine that it started out with probably $5,000 or $10,000 cash capitalization, and I do not want to stifle little companies like that; put them out of business.

Now, you say that that company could not meet any overhead. Well, that is true, On $10,000, income from $10,000, it would not be able to; but now that company is protected, and cared for in this bill all right. I want an explanation if it is not. I would rather have a thousand dollars in the Sneed Investment Co., or $10,000 in it today. It has grown up some. I do not know how big it is. It is probably not over $100,000 today. It is only operated by a man and his wife and they probably work a half a day about, and with one salary drawn out of it. I would rather have some money in that company than to have it in one that maybe had a million dollars invested.

Mr. SCHENKER. I do not disagree with you. There is one question that I would like to ask. Do you know how many people are participating in that fund as stockholders; who owns the securities of that firm, about how many?

Mr. BOREN. I could not guess; but many. It is a public offering. I would say at least a thousand or maybe 2,000, because I happen to own a certificate in it, and I know people in various parts of the State who do.

Mr. SCHENKER. Of course, this bill does not put that company out of business.

Mr. BOREN. No; but it does not permit another company of the same character to go into business. That is what I am talking about.

Mr. SCHENKER. There are no two ways about that. This bill says that they cannot do it.

Mr. BOREN. That is what I am objecting to.

Mr. SCHENKER. Judge Healy indicates that you have to, with respect to all the provisions of this bill, consider that it is hard to visualize a provision which may not accomplish some undesirable things or do an injustice to a particular individual. When you deal with a subject like investment trusts on a national basis, you have to balance advantages as contradistinguished from disavdantages.

Mr. BOREN. Well now, that is true; but here I have pointed out to you an injustice to a possible small company, and we have many of them in my State that had a $25,000 or $50,000, or $100,000 beginning. I do not know that there were many such companies which come under the characterization of this bill; but I would say that several would.

Now, as I see it, this would have a slight effect perhaps from a national standpoint, but it would have a serious effect on little fellows like that.

Now, if you turn it around the other way, I do not think if you look at it from the other angle, the large companies, I do not think that $100,000 is a drop in the bucket from the standpoint of protection. I do not think it is worth a dime. I am not satisfied with that provision at all. I think you just as well have nothing, because what is $100,000 to require of a group of men in New York City who are going to come down into my State and sell millions of dollars' worth of security? We have been supporting Wall Street out of Oklahoma oil, and Indian income, for years and years, and we have had no protection. What is $100,000 or $1,000,000 to some of them who have sold securities in my State?

Mr. SCHENKER. If we could work out a formula that would consider men like the Sneeds, and other people of that character, we would be delighted to do it.

Mr. BOREN. You are still looking at this one subject. What protection is $100,000 to me from the company that you are really trying to regulate here? You are willing to let the Sneeds out, as I understand it, and the people of that type; but what real protection do I have from a paltry little $100,000 from those companies?

Mr. SCHENKER. Well——

Mr. BOREN (continuing). From those big firms.

Mr. SCHENKER. This $100,000, as I said, is not intended to give you any added cushion to the security holders of the company. If you put in $100,000,000 in the Lehman Corporation, you have $100,000,000. That pool is the funds of the stockholders. But, at least the $100,000 provision will stop the irresponsible person who has no financial backing, who asks the people to hand over their savings to him, and allows him to go throughout the country trying to obtain the savings of the people.

Subsection (c) of section 6 has been included, in order to deal with those types of situations which you cannot possibly anticipate the possible contingencies that you will meet. Subsection (c) of section 6 permits the Commission to exempt persons, transactions, or companies, upon conditions.

Mr. BOREN. That, of course, could take care of the little fellow I am talking about; but still I do not see any value to the $100,000 from the other fellow, unless we have the remote value of keeping a few out; outsiders from going into the business; but it would not be

practical to make an exemption on the basis of the extent of the offering of the securities. I mean, you could not go down and regulate the little company that operates all within one State or all within one county, perhaps.

Could you work out an exemption of that character?

Mr. SCHENKER. What we would like to do, Congressman, is to consider an approach to this problem. We were not unmindful of these problems, and we are conscious that there is a great deal in what you you say; but we have a background from our studies, which shows that the experience of investors in small companies has been simply awful. The Sneeds case is a rare case. We may be able to take this approach; if the company is a local company or confined to one State with limit to the size of its public offering, we might be able to substantially reduce the amount of money that the company would need to start with. How would that be?

Mr. BOREN. That would be exactly what I have in mind from this standpoint. Then if we do that, I would want to see this $100,000 substantially raised to take care of the other side of the picture.

Mr. HEALY. Would you reserve your judgment on that point until Mr. Schenker has had a chance to point out the other protective provisions in this bill in connection with the issuance of senior securities?

Mr. BOREN. Referring to the larger companies.

Mr. HEALY. Yes.

Mr. BOREN. Well, if you will keep in mind that other angle, because I do not know how much you gentlemen realize that particularly in a small midwestern and mountainous community, and so forth, the desperate need for the development of local industries, which often calls for the creation of a very small investment company to meet a particular need. My State is carrying on a terrific program now to try to start little industries, and trying to finance them through little firms created among the fellows who have the money, like peanut factories, and things of that character, and I am afraid we cannot do it unless we take care of that, and I want to take care of them if we can do it without weakening the structure of the bill. I do not want to work a desperate hardship on that type of men.

Mr. COLE. As I understand, your studies disclose that from the investor's standpoint they took a terrific walloping from a lot of these little fly-by-night companies.

Mr. SCHENKER. Not only that, but even where they were not exactly fly-by-nights, Mr. Cole, the investors suffered substantial losses. If you look at the profit and loss statements of these companies, you find that the salaries and expenses devoured all of their income. Small-sized companies just did not work. You have to pay officers, and no matter what you pay them, most of the dividends and interest from the portfolio securities are absorbed for this purpose.

Mr. COLE. Is that not very often the purpose of a great many of them?

Mr. SCHENKER. And yet, you may have the situations that Congressman Boren is talking about.

Mr. COLE. Now, one other question. Are we to understand that section 6 (c) contemplates pretty liberal exemptions of companies under $100,000?