any property to an investment trust, because you are sitting on one side representing yourself where you have a pecuniary interest, and you are sitting on the other side representing the investment trust; and we say that fundamentally that should not be permitted. If that provision had been in effect at the time of the Groves incident and these numerous other cases we will tell you about, then you would not meet this complicated problem of whether the transaction was fair or unfair.

One of the lawyers involved in the *Continental Securities case* told Joe Patrick, of our office, who helped work on the case with me—he said, "Do you think I as a lawyer would have been crazy enough to try to sell the stock to this investment corporation when there was a direct, unequivocal statutory provision saying that a controlling person cannot sell such stock? I was figuring that I was going to go before a jury."

When you deal with investment companies, because of the peculiar nature of their assets—they deal in securities—it is difficult to convince a jury in certain situations.

That is the approach of this bill, Senator. We tried to set forth broad standards to prohibit transactions like the ones that have been recounted, because we know the difficulty of trying to convince a jury of larcenous intent and conspiracy. We say it is fundamental that these people who deal with investment trusts should not be able to do so if they control investment trusts.

Senator WAGNER. Have you concluded?

Mr. SCHENKER. I am through, Senator.

Senator WAGNER. We will hear Mr. Mathews.

STATEMENT OF GEORGE C. MATHEWS, MEMBER OF THE SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER (chairman of the subcommittee). You are still a member of the Securities and Exchange Commission, are you not, Mr. Mathews?

Mr. MATHEWS. I am.

Senator WAGNER. Unfortunately you are soon to take leave of that Commission and go into private business, I understand. I want you to know that we all regret your departure.

Mr. MATHEWS. Thank you, Senator.

Senator WAGNER. We recognize the very fine service that you have given to the country.

We would now like to hear from you with reference to this legislation.

Mr. MATHEWS. About all that I want to do with reference to the bill now before you is to state as clearly as I can my position on the question of regulation of investment trusts. It is a characteristic of these organizations that, through them, a body of small investors turns the handling of its funds over to others. Even under the most ideal conditions the individual investor is without any means of effective participation in the management which handles his money. Furthermore, a great many investors turn to the investment trusts for the very purpose of turning over to experts the problems of investment management which they do not feel competent to solve for themselves.

Speaking in general terms, the investment trust has not supplied capital to industry. The exceptions have been trivial and unimportant in their relation to our economy. Regulation cannot be charged with having the effect of stifling industry. Again speaking with individual and negligible exceptions excluded, the only real function which makes the existence of these institutions important to the country is that they supply a means by which a great number of investors may own a shore in industry with such advantages as flow from diversification of investment and employment of expert management. At their best, investment trusts serve these purposes. At something less than their best, the reputed advantages of diversification and of expert management are more than offset by the dangers which the mass of investors encounters in them.

Their history sufficiently shows that investors need the protection of effective regulatory legislation and administration.

You have a specific proposal before you. It seems to me too much to expect that proposals for legislation which had not been subjected to the searching criticism of your legislative hearings should represent in all respects what should emerge as law. My study of the reports resulting from the investigation and of the bill as it was introduced convinced me that measures of control provided by the bill which has been introduced were sufficiently supported by the record of the investigation that for us to recommend substantially less would not fulfil our duties to the Congress.

I do not suggest that as it stands the bill is in such a stage of perfection that it may be accepted as ready for enactment without the most critical examination. I have seen too much of the improvement process through which legislation goes after it reaches the stage of legislative hearings for me to take that position.

There is no doubt of the need of effective and comprehensive regulation. A form of control which is less than that may be about as dangerous to the public as complete freedom from administrative restraint. I would be very much opposed to any program which, under the mask of regulation, sought to do more than to impose those restraints upon management which are really necessary for the protection of investors, but any course which does not impose those restraints may be very misleading to those whom it professes to protect. Fortunately this bill deals with a business such that the fullest measures of control required to safeguard investors cannot with any pretense of logic be made to appear to have a depressing effect upon the national economy.

I have no further statement to make. I merely wanted to state my views, Senator.

Senator WAGNER. Have you any questions, Senator Hughes?

Senator HUGHES. I think not. I understand the viewpoint.

Senator WAGNER. I gather from your statement that your knowledge of these experiences comes from a study of the report. You did not yourself participate, I understand'

Mr. MATHEWS. No. I did not attend the hearings except incidentally and for very brief periods.

Senator WAGNER. And your considered judgment, as a result of your study, is that in order to protect the investor in this type of investment it is essential that there be some public regulation?

Mr. MATHEWS. I think there must be some public regulation, and I think it must be far-reaching public regulation.

Senator WAGNER. You do not think that this bill is too extreme in its proposals?

Mr. MATHEWS. I have not been able to see anything in the plan of the bill or its scope, anything of substance, that I could not subscribe to. I would like to make it clear, however, that I have no notion that in every detail of the bill it is just what you want to pass.

Senator HUGHES. I understand that you think that a mere gesture at regulation might be more dangerous than having nothing?

Mr. MATHEWS. I think it would be perhaps worse.

Senator HUGHES. Because it would be misleading, and the people would think that there was something being done, that there was a law that protected them, when it really did not do so.

Mr. MATHEWS. Well, we have all seen the case of States where banking regulation was inadequate. We have seen States where insurance regulation was inadequate. The public, I suppose, relied on the fact that there was such State regulation—relied, to its great loss, on that fact. So that I say there is not a really middle ground. I think if you do not have a comprehensive and effective program of regulation, it is probably better to have none.

Senator HUGHES. Yes; I have seen that. You have the machinery, you have the offices, and people think that the insurance commissioner or the banking commissioner or whoever it may be has all the necessary authority and that he is protecting them, and the thing must be all right, when, as a matter of fact, it is not so.

Mr. MATHEWS. That is right.

Mr. Schenker suggests that I have omitted one thing with reference to the basis for my conclusions. I was in charge of the administration of the State blue sky law for a considerable number of years at about the time that these investment trust securities were being sold very actively, and even before this investigation was started I was convinced of the need of a pretty thoroughgoing program of regulation, although I had not by any means thought the matter out to the point where I could make specific proposals.

Senator WAGNER. I do not see what other answer there can be. One of the very distinguished members of this committee has told me, "I have listened to enough facts to satisfy me that there has got to be regulation." Of course, we want to hear all sides, and also we want to hear criticisms as to the detail of the proposed legislation.

Mr. MATHEWS. If the substance of our reports could be boiled down into a short readable book, I do not think anybody could read it without being convinced of the necessity of regulation. To leave the door open for a repetition of what has happened over the past 10 or 15 years is little short of criminal; and I join with Mr. Schenker in wanting to be understood as not accusing the entire industry; but with the possibilities there, if the ability to market securities should suddenly step up, unless there are restraints in general such as proposed in this bill, the opportunities for going to the public and getting control of their funds would be such that the industry is bound to attract to itself again the very class of people who brought it into bad repute in the past. It could not be avoided.

Senator WAGNER. We are going to hear those who have criticisms of the legislation. The facts that have been related to this committee persuade me that the Congress would be careless in its duty if it ignored these facts and made no effort in some way to prevent their recurrence in the future.

Mr. MATHEWS. Commissioner Healy has raised another question with me. We think of investment trusts popularly as a type of business in which a security is sold to the public. The public's money is obtained, and the transaction is closed. Now, there are two other types of institutions within this general field. One of them has characteristically been a trust superimposed on a trust. That is, the assets of the top trust were the certificates of the lower trust, and characteristically the securities of the top trust were sold to the public on a basis which included a load on both of them; those loads meaning, as I recall, from 12 to 20 percent of the underlying assets. They are sold on the installment plan basis, so that they are put in a form to make an appeal to the person who really wants to make a conservative type of investment into which he can put his savings year after year, over a period of 10 or 12 years.

Another type of the installment plan company is the one that issues a fixed amount of certificates, promising to pay back at the end of X years a fixed number of dollars in return for the payment to the institution of so many dollars a month over that period.

Those are peculiar institutions which appeal to the saving instinct in people, the desire to adopt a continuous carefree program of investment.

My conclusions are not entirely final as to some features of the face amount certificate companies, but our experience has been, I believe it is safe to say, that they would not be alive if it were not for the fact that there is a tremendous mortality of those contracts, with either no recovery to the investor if they are surrendered within an early period, or with a surrender value much less than the amount paid in. Where you have that tremendous mortality, obviously with losses to the people who surrender to help to keep the business going, when perhaps if I held my certificate to maturity it might help me as an investor. But the whole question is raised as to whether they are selling, as to whether the essential nature of the business is to sell to the investor certificates which he holds to maturity, or whether the essential nature of their business is that of a business which is primarily one of selling something to the customer that they know he will not keep and that he is bound to take a loss on.

The experience has been so overwhelming that it may not be unfair to characterize the business as one which is primarily a business of selling to people who are persuaded that they ought to make a conservative investment over a period of years, something which experience shows will never be carried out, and where experience shows that the bulk of the purchasers are bound to lose part or all of their money, because the purchasers do not or cannot keep up their payments.

Senator WAGNER. Thank you very much, Mr. Mathews.

Senator HUGHES. I am acquainted with some of those experiences.

STATEMENT OF BALDWIN B. BANE, DIRECTOR, REGISTRATION DIVISION, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER (chairman of the subcommittee). You are chief of the Registration Division of the Securities and Exchange Commission?

Mr. BANE. Yes, sir.

Senator WAGNER. The committee would like your views on the pending legislation.

Mr. BANE. I would like to deal, Senator, with the type of trust that is frequently registered with the Securities and Exchange Commission.

You remember that Judge Healy said that approximately 1,300 trusts, if I remember correctly, had been created in the last 15 years, of which some 650, or approximately half of them, were still in existence.

He also referred, I think, to the peculiar characteristics of investment trusts and to the fact that disclosure under the 1933 act, that is, the Securities Act of 1933, is inadequate as a remedy to prevent certain of the generally admitted abuses in the industry and to the effects of those abuses on the trusts, on the security holders, and on the profits derived by the so-called insiders, the underwriters, sponsors, and dealers.

Although there are about 650 investment trusts at present in existence, only about 265 of the 650 have registered with the Securities and Exchange Commission under the Securities Act of 1933.

Between July 7, 1933, which was the first date that you could register under the act, and December 31, 1939, approximately 4,300 registration statements have been filed under the Securities Act. They cover an aggregate offering of something over $15,000,000,000, and the largest part of that offering is, of course, bonds, debentures, and preferred stock. The common-stock offering is only something over $4,000,000,000. Of that $4,000,000,000 which can be compared to the type of securities sold by the ordinary investment trust, because the security ordinarily sold by the investment trust is merely an equity security, we have registrations from these investment trusts of more than 50 percent of that total of $4,000,000,000. That is something over $2,161,000,000 registered with us under the Securities Act by these so-called investment companies.

Of the 265 that registered with us, as near as we can determine from a recent survey only approximately 130 of them are now in existence. and not all of the 130 are at present actively selling.

These investment trusts are as easy to form as they are to disappear. In fact, it is probable that they are too easy to form. Practically all you have to do is to draw up a so-called trust indenture or agreement, setting up a so-called trustee who, in reality, is little more than a custodian, granting powers to the managers and sponsors, limited only by the consciences of those managers and sponsors. Then you start manufacturing your securities and peddling them to the public.

Senator WAGNER. There is nothing in the law that prevents that, is there?

Mr. BANE. As it stands today, no, sir.

As a general rule, a small block of securities is first offered to the public at a fixed price, in order to secure money to buy securities for the portfolio of the trust, and after that the securities are sold at a price based upon the value of the securities in the underlying portfolio.

These securities, we have found, are generally sold as an investment to persons of small means and as an alleged safe investment to people who understand saving but have little knowledge of investment.

As great an advantage as are disclosure and publicity, and as the Securities Act of 1933 has shown them to be, there are certain practices generally engaged in by investment trusts and so generally admitted, even by the members of that industry, to be bad and of such evil effect that they should be either restricted or entirely prevented, and particularly when you consider the type of person to whom the securities are principally offered and the complex and technical nature of many of these abuses and the effects that flow from them.

I want to point out just a few of those abuses which this bill will either wholly prevent or tend to prevent; and I am going to talk not about the type of investment trust that you have been hearing most about, as I understand the hearing so far, but the type that is mostly registered with us. It is a type that originated largely and has grown in the thirties. That is the open-end management investment type—meaning a management company which is offering its securities for sale or has outstanding redeemable securities which it has issued. This type, as I said, constitutes by far the largest type registered with the Commission.

The companies of this type sell unissued and redeemed securities to the public at a price determined by the market value of the securities in the portfolio of the trust as of a particular time each day, and the moneys thus raised are used to buy additional securities for the portfolio.

The theory back of these trusts is that the new member should pay for his share an amount equal to the proportionate equity of the existing shareholders at the time the new member comes in. In most of these companies practically all of the portfolio securities are listed on either the New York Stock Exchange or the New York Curb Exchange. Because of this listing the value of the portfolio can readily be calculated shortly after 3 p. m. each day. That is the time at which the New York market closes. From this value all liabilities of the trust are deducted, and the resultant figure is divided by the number of shares outstanding, and that gives you what is generally referred to as the net asset value per share. To this net asset value there is added what is generally called a load, which means a certain percentage of that value, generally about 8½ percent, though it varies among trusts, is added to cover all selling costs, and the profits for the distributors.

This price determined shortly after 3 o'clock each day, as a general rule among the trusts, is practically never used as a basis for the sale of these securities as soon as it is determined. It varies among the trusts, but generally it does not go into effect until 10 a. m. the next day. The price which went into effect at 10 a. m. on any day remains the same until 10 a. m. of the next day, even though the value of the securities in the portfolio, and therefore the net asset value of the shares, is substantially higher in the interim because of a rise in the market price of the underlying portfolio securities.

The fact that the price from 3 p. m., or approximately that time, to 10 a. m. the next day is less than the price to go into effect at that time, that is, at 10 a. m., is stressed repeatedly in order to sell these securities to the public. It is used as one of the principal selling arguments.

Thus there are two known and determined prices in existence in such cases from shortly after 3 p. m. to 10 a. m. of the next day, practically for 19 hours out of every 24.

Let me contrast this situation with that of the ordinary purchase of a listed security.

One walks into a broker's office about 10 or 10:15 in the morning and asks what the price of United States Steel common is, for example, and he is told $55 a share. He decides he will wait a while and see what the market does. He learns some time later in the day, after the market has closed, that U. S. Steel closed at $59 a share, up $4 above what it was in the morning. He probably wishes that he had bought steel at $55. But now he cannot buy it at less than $59, because even though he buys after the close of the market, that market close is generally the price that will prevail until the opening of the market next day.

In the case of investment-trust shares, however, the situation and the basis of sale are entirely different. Even though the securities in the portfolio and, therefore, the asset value of the trust certificates, just like Steel, General Motors, General Electric, or any other securities listed on the exchange, fluctuate—for example, assume that at 10 o'clock in the morning the shares of a particular investment trust are selling at $55, these investment trust shares of course will change in value, but not in price, throughout the day as the price of the underlying portfolio shares changes. Let us assume that at 3 p. m. when the stock market closed the underlying portfolio shows that the trust share now is worth $59. Every one knows that the trust share has risen $4 in value at that particular time.

However, there is one big difference right there between buying Steel stock and buying the stock of this investment trust whose value depends upon stocks like Steel listed on those same exchanges. People who wish they had purchased steel shares at $55 cannot do it; but the person who wished he had purchased the trust shares at $55 may still buy those shares at $55, and in the usual case he may still buy them at $55 up until 10 o'clock the next morning. In other words, he can buy a share at what is then known to be $4 below its worth. If we suppose that he has one share, that one shareholder now has an appreciation of $4 in his share; but the other man, knowing that he can buy into the same thing for $4 less than that, $55, buys in, and another Steel share has to be put into its place which has to be bought at $59, or if the market goes up it may have to pay as high as $61 or some other figure. He gets another Steel share in there, but he gets a portfolio interest in there at $55.

This one man who had a share at $55 now finds two shares in at $55. The $4 appreciation that he had in the portfolio has been divided between the two. So the appreciation earned by the one share in the trust has been cut in two.

That is what is generally referred to in the investment-trust industry, and that is what I will refer to when I use the word here, as dilution. The interest of that first security holder has been diluted by allowing the second security holder to go in and purchase at less than the value of the share at the time he bought it.

The extent of that dilution depends, of course, upon various factors, the amount or the difference in price between that at which he could buy and the actual value, the size of the trust, and so forth, and the amount that you sell, as compared with the amount already in the trust.

This example demonstrates the principle upon which the little understood two-price system, to which I will refer throughout this discussion, in the investment-trust industry, works.

The two-price system is, in the financial world, I suppose, a distinct peculiarity of the investment-trust industry. In substance, in this industry people are urged to buy trust shares at a time when it is known that the price to go into effect at a later determined time is higher than the current offering price of the shares, and they are urged to do it, to the dilution of the trust, by buying at the lower of the two prices, even though the shares are worth the higher price.

Conversely, the two-price system affords the purchaser the opportunity to withhold his order until the following day, when he knows that the new price to go into effect is lower than the current offering price.

The two-price system results in a substantial dilution to the trust, and some of the trusts have quite recently taken steps in an effort to reduce, to some extent, the amount of that dilution, by shortening the time within which these two prices are in effect.

The great volume of sales in investment-trust securities, from 70 percent to 90 percent, are made on a rising market—that is, when the next day's price will be higher than the present price. When the market is down—nobody wants to buy.

Several bad results flow from this. The salesman is able to and does go out and offer the securities at less than their known and established values. In many instances he is urged to do so by the sponsors and underwriters, those occupying the fiduciary relationship to the trust.

When the securities are sold at less than the value as established from the portfolio of the trust it means that the trust does not receive sufficient funds to buy the proportionate interest in the portfolio as represented by the securities sold, and thus the interest of all present security holders is diluted, the extent of such dilution depending on the size of the portfolio and the sales made at the lower price.

This dilution occurs whenever securities are sold at less than the proportionate value which they represent in the trust, regardless of whether two established and known prices exist at the same time. For instance, if prices were determined each day shortly after the close of the market at 3 p. m., and no sales were made thereafter except at the price thus established and the market rose during the next day, there would still be dilution as long as shares are sold at prices at the close of the market of the preceding day and that close was lower than the price during the next day.

The two-price system merely accentuates that dilution and enables it to be used as, and it is used as, one of the principal selling arguments by many of the open-end investment trusts.

In September 1939 the stock market took quite a rise, and we undertook a study to determine the effect on the trust, the existing security holders, the underwriters, and those who came in during the period from September 1 to September 21, of dilution resulting from the two-price system.