Just one other thing before I go to the analysis of the bill. In these installment investment plans, and that is true also with the open-end companies, there are some companies who perpetrated these practices, and they came to us and they talked to us and they said, "Well, we will make these changes," but the unfortunate thing, Senator, is that this is a highly competitive business. Now, he might be prepared to follow certain principles, but there is no provision in the law which says that everybody else has to subject themselves to the same provisions or limitations. Therefore a person engaged in sponsoring an installment plan, who wants to do the right thing, finds himself handicapped, because the next day a different individual can organize a company and he is under no compulsion or duress, and there are no sanctions which compel him to comply with any standard that the good people in the industry set.

All of the abuses in the installment companies have not been eliminated. I think they have manifested good cooperation. I think they are convinced, as we are convinced, that you cannot meet that problem unless you have legislation.

Although I do not assume to talk for them, my definite belief is that the provisions we have formulated meet the problem substantially and they are prepared to accept them—in fact, they would like to see them adopted—and I think the representatives of that branch of the industry would say so if they were requested to come here.

Senator, before I commence the fairly detailed discussion of the provisions of the proposed legislation or bill, I would like to make one observation. Nobody is more conscious than I am, Senator, of the difficulty of saying in precise language what you intend to accomplish. Now, our experience has been, for instance, that in connection with the preparation of the questionnaire that we sent to the entire investment-trust industry, we had a rough draft, we conferred with the industry, and they were of incalculable help, because you say something and it accomplishes something diametrically opposed, or does things that you did not intend it to do, or accomplishes something you did not intend it to accomplish.

Now, the probabilities are that in a bill of this size there are such situations. I personally and the Commission have had the finest relationship with the industry. I will say this unequivocally, Senator: We have had the utmost cooperation of these people throughout the entire course of our study. I think it is unfortunate, and I am not being critical, Senator, that the industry did not do all they could have done. Whether they were too busy or whether they were trying to ascertain the full scope of this legislation or trying to see if we had any sleepers in the proposed legislation, the fact of the matter is that by and large after the bill was introduced few people from the industry conferred with us. There were some who came to us and indicated that a mere change of a word here would not change the substance, yet would either tighten the bill or eliminate the "bugs" in the legislation. I am candid and frank and happy to admit that those people have been of great help to us. However, although we made the announcement that we were prepared to discuss it with them, it has not happened.

Senator WAGNER. Have you had any conferences at all?

Mr. SCHENKER. Not the same type of conference, Senator, that we had before the bill was introduced. I want to make this clear.

I am not being critical. They probably had a man-sized job on their hands studying the bill and getting all its implications, but the only thing that I and the staff and the Commission feel is that there probably are some little phrases or a misplaced comma that might accomplish something we did not intend to do. What we want to do is to give you the broad purposes of the bill and try to illustrate what is aimed at, the different approaches that you can take to the problem, and why we selected the particular approach that we did.

Now, section 1 is the usual preamble to a bill and just sets forth the findings upon which the bill was predicated and incorporates by reference the reports and the studies of the Commission.

Section 2 contains a broad statement or declaration of policy—what the bill, when it becomes an act, hopes to accomplish.

Now, in that respect, Senator, and I am not going to elaborate on that, I think the declaration is clear on its face and so are the findings. In that respect I would like to read a statement made by Mr. Justice Stone before the Conference on the Future of the Common Law, held August 19, 1936, which is reprinted in 50 Harvard Law Review 4, at page 15:

> I observe in recent statutes a revival of the ancient practice of stating in them the reasons for their enactment. The reasons were addressed, it is true, to the removal of constitutional doubts, but the practice can similarly be made an aid to construction. As the force of judicial decision is enhanced by the reasons given in support of it, so the union of statute with judge-made law may be aided by the statement of legislative reasons for its enactment, or by a more adequate preservation of the record of them in its legislative history.

That is one of the things that impelled the Commission to recommend that the bill incorporate in the form of sections, which are really a preamble, what our findings were and what the purpose or policy of the bill is.

Now, coming to the substantive provisions of the bill, section 3 defines an investment company, and that problem required a great deal of thought and care. In the popular mind an investment company is a company which is engaged in the business of investing, reinvesting, holding, and trading in the securities of other corporations. Section 3 (a) (1) says that an investment company includes a company which says it is an investment company and engaged in the business of investing, reinvesting, or trading in securities.

There are situations, however, where that purpose is not so definitely stated.

Paragraph 2 of section 3 (a) sets forth what we call a statistical formula which will be of assistance in determining whether a company is an investment company or is not an investment company. Substantially, what does section 3 (a) (2) say? It says that a company, a very substantial part of whose assets consists of marketable securities, is an investment company, and that a company which is an industrial corporation, although it may have up to 40 percent of its assets in marketable securities, is not an investment company. That will eliminate all industrial companies which may have invested a substantial part of their funds in fairly small blocks of the securities of other corporations.

We took this formula and checked it against 1,800 companies which registered with the Commission under the Securities Act of 1933 or the Securities Exchange Act of 1934. We excluded all companies which considered themselves investment companies. When we

analyzed the balance sheets of these companies we found that although in the aggregate they had $5,000,000,000 of marketable securities—and by "marketable securities" we mean securities other than the securities of their subsidiaries—very, very few companies were caught by this formula. In order to take care of even those few companies, we have made specific exemptions.

Our approach is that an investment company, for the purposes of this proposed legislation, is a company which is engaged in the business of investing and reinvesting in securities, or is a company which invests and reinvests or holds securities of other corporations, provided that at least 40 percent of its assets consists of marketable diversified securities.

We have set forth this definition in our first report that we transmitted to the Congress back in 1938.

The number of instances that have created difficulty are really negligible. There was only one instance, as I remember it now, where there was some doubt as to whether this formula caught that company as an investment company, and we have made provision for that situation.

What do we go on to say? We say that even if you find that more than 40 percent of the assets of a company are in marketable securities, securities of companies which are not its own subsidiaries, we still say that it cannot be an investment company, within the purview of this legislation if—what? If this company is engaged primarily directly or through wholly owned subsidiaries in a business other than that of investing and reinvesting or trading in securities.

That means what, Senator? It simply means this. Take the Standard Oil Co. The top holding company holds securities of all its subsidiary operating companies. We are not even remotely interested in holding companies. They are not within the scope of this legislation. The Commission does not want any part of that type of situation. So if you take that type of company, even though it may fall within this 40-percent provision, we say it is not an investment company. We say, "You are not within the purview of this legislation if you are primarily engaged in any other business even though you may have a substantial part of your assets in marketable securities."

So that such holding companies are specifically exempt. That will fortify the exemption of companies which are essentially industrial corporations or railway companies which may have a substantial part of their assets in marketable securities.

Then we say, further, that even if you may fall prima facie within the statistical formula, if you can prove that even though you do not do your business through wholly owned subsidiaries but through majority-owned subsidiaries, if you make out a case that you are engaged in a business other than investing and reinvesting in securities, you will be exempt.

Then we go on further to a situation where we have an industrial corporation that has a substantial part of its assets invested in marketable securities. If for some reason they see fit to take that portion of their activities and put it into a wholly owned subsidiary, instead of having their transactions in marketable securities, a sort of division of the company, we say that that wholly owned subsidiary is not an investment company.

Senator WAGNER. That is so, even though the subsidiary might engage in the business of buying and selling securities?

Mr. SCHENKER. On that aspect, Senator, we do not want to let ourselves in for a lot of circumvention, and the test there is: What is your primary business? Suppose there is a company with assets of $100,000,000 that has a small chemical factory worth $2,000,000, and takes $99,000,000 of its assets and puts them into a subsidiary to speculate on the New York Stock Exchange. That is an investment trust.

We say if, looking at the whole picture, his primary business is the chemical business, then the fact that he has a number of his assets in a wholly owned subsidiary which invests and speculates in securities of other companies, does not make him an investment company.

Senator WAGNER. That is where there is discretion. That is not a fixed proposition?

Mr. SCHENKER. No; that is not a fixed proposition. As we go along, Senator, I will try to elucidate those things that prompted us to recommend to your committee that the Commission be given the power to make rules and regulations in connection with that matter. You cannot set down hard and fast rules. I can give you instances showing that it is really doubtful what the primary business of a company is. Are they engaged in speculating in common stocks on the New York Stock Exchange, or are they engaged primarily in the business of manufacturing or in the chemical industry or the banking industry?

Senator WAGNER. I did not intend to be critical.

Mr. SCHENKER. I am glad you raised the point. I do not know whether I have made this clear or not; but with respect to a company which is engaged in a business other than investing in securities through wholly owned subsidiaries, we have no discretion in that at all. That company has an exemption, because, if you will look at the set-up of that type of company, what do you find? If you just pierce the corporate veil and get rid of the legal fiction that every corporation is a separate entity, and just go down from the top holding company to the operating company, the top holding company is really engaged in the operating business. For instance, the Standard Oil Co., the top holding company, is in the oil business. It is not in the business of investing and reinvesting in securities.

In the closer cases, not where you have the top company operating through wholly owned subsidiaries, the closer type of case is this, Senator—and that is what this provision was intended to meet; I mean, section 3 (a) and section 3 (b) (2). Take, for instance, Senator, some investment companies: Their primary business is something like this: Instead of buying securities listed on the New York Stock Exchange and trading in them, they buy big blocks of stocks in particular companies and stay with the investment for a substantial period of time.

Take the Phoenix Securities Corporation. It virtually has no marketable securities in the sense that it has a portfolio of New York Stock Exchange listed securities. A substantial portion of its money is in its control of a block of stock of the United Cigar Co. Another substantial portion of its assets is in Celotex, of which it owns 30 percent. A substantial portion of its assets is in the Autocar Co. A substantial portion of its assets is in the controlling block of stock in the New England Bus Co., and a substantial portion of its assets is

in the Southwest Corporation, which is in the sugarcane business. Recently they found oil there——

Senator WAGNER. What is the name of that company?

Mr. SCHENKER. The Phoenix Securities Corporation. A substantial portion of its assets is in the Loft Co., Inc., which in turn controls the Pepsi-Cola Co. that you have been reading about in the newspapers.

The Phoenix Securities Corporation is not in the business of running cigar stores, not in the business of manufacturing Celotex or raising sugarcane, but has investments in those activities. It is not primarily interested in the manufacture of sugar. It is interested to the extent that if the sugarcane business picks up and makes money, the price of its stock will rise and it can sell its stock at a profit.

So you have this gradation of corporations from the situation where it is clear that the holding company is really engaged in an industrial enterprise to the other extreme where it is clear that the investment company owns small blocks—100 or 500 shares of United States Steel—and cannot even remotely be considered as being in the steel business. Somewhere along that area you have to draw a line as to when it is an investment company and when it is an operating company. And it is with respect to that situation that the Commission says, "You have to make an application so we can take a look at your activities and your assets and then determine whether you are an investment company or not.

I think this also has to be borne in mind, Senator. There is nothing arbitrary or despotic about that. If any individual is aggrieved by a decision of the Securities and Exchange Commission he has a right to appeal to a court to get a judicial review of the action of the Commission on the aspect of whether he is an investment company or not.

Whom else do we exempt? You have the situation where there are personal holding companies. A family may have a substantial estate and has invested its money in marketable securities. In essence that is a private investment company, is it not? We do not want any part of it; and so we have said that even though you engage in the same type of activity as an investment company, which is within the purview of this section, if you have less than 100 security holders you are not a public investment company and not within the purview of this legislation.

Senator WAGNER. Less than a hundred?

Mr. SCHENKER. Yes, sir.

Senator WAGNER. Irrespective of the amount of securities they may have.

Mr. SCHENKER. Irrespective of the amount of the total assets they may have?

Senator WAGNER. Yes.

Mr. SCHENKER. That is right. The total assets play no part in the determination as to whether a company is a public investment company or a private investment company, because, Senator, these public investment companies run as low as $30,000 or $25,000, and run as high as $121,000,000. The size is not the definitive or determinative factor. The factor which determines whether you are within the purview of this legislation or not is, first, are your activities those of an investment company? Second, are you a public investment company?

In order to prevent easy circumvention of the provisions of the law so as not to come within its scope, we have provided for that on page 7, section 3 (c) (1). Let me give you an example, Senator.

Suppose an individual decided to form an investment company, and he organized an investment company, and then on that company he superimposed another company by having the first company he organized issue all of its stock to the superimposed company. Then the superimposed company sells its securities to the public. The lower company has only one stockholder—the company that was superimposed on it. However, the public has indirect participation in the lower company by virtue of the fact that it is buying the securities of the company which has been superimposed on the lower company.

Unless there is a provision like that, then it is a simple matter to evade it, if the requirement is that there has to be a hundred stockholders. All he has to do is to interpose between the company which is going to be the investment company and the public a corporation which will own all the stock of the investment company. Do you understand, Senator?

Senator WAGNER. Yes.

Mr. SCHENKER. So that this provision says that in computing the number of stockholders to determine whether there are 100 or not, a corporation counts as one stockholder. However, if it has a substantial interest in that investment company, then in computing the number of stockholders to determine whether it is an investment company or not, you have to count the number of stockholders of the corporation which holds a substantial interest in the investment company. Otherwise all they have to do is to superimpose one corporation on the investment company and they are without the purview of this bill.

Senator WAGNER. Just on the general statement that you made, what is the reason? Is there some very good and sound reason for having one company superimposed on another? Is it an improper device, or are there very good reasons for that method of financing?

Mr. SCHENKER. The method of financing depends, in my opinion, upon——

Senator WAGNER. I am only asking for an opinion, because there may be a contrary view, you know.

Mr. SCHENKER. I understand that, Senator. In our opinion, as far as the investment company industry is concerned, not only is there no useful function served by pyramiding one company upon the other, but we feel, and we will elaborate upon that when we come to the sections relating to pyramiding, that it is a distinct disadvantage to the stockholders. In essence, pyramiding is nothing but a device whereby insiders get control of substantial amounts of the public's funds without any substantial investment on their own part. All they have to do is to get control of one company and then to use the funds of that company to buy another, and use the funds of that company to buy another. When we discuss that provision we will show you the lengths to which that has been carried on, and we will also show you, Senator, the extent to which it prevails at the present time.

Senator WAGNER. We have had some instances that have been pretty definite. You mean, you are going to show us other cases in addition to Continental and Founders?

Mr. SCHENKER. The Founders was a very complicated pyramiding system. The Equity Corporation was a very complicated pyramiding system. But if I may interrupt just a second—because you raised this question, Senator——

Senator WAGNER. I do not want to divert you too much.

Mr. SCHENKER. Possibly the most expeditious thing would be to wait until we come to that provision, so that we can show you the situation as it prevails at the present time.

In any event, the problem I have been talking about, Senator, is a little different from the one you suggested.

I am not addressing myself to the abuses of pyramiding. At the present time what I am trying to show is the reason why in some instances you have to consider a corporate stockholder in an investment company more than a single stockholder, because that company may have a very substantial interest in the investment company, and probably may have a very substantial interest in the corporation which has a substantial interest in the investment company.

We specifically exempt these personal holding companies, as I said. We specifically exempt all persons, or substantially all, whose gross income from securities or security transactions is derived from either acting as broker or from the distribution of securities issued by others. In essence, what are we doing there? Although a broker is engaged in the business of buying and selling securities, he is not an investment company. What we say is that if you have an incorporated brokerage firm and it has more than a hundred stockholders, if its business is the brokerage business, it is not within this act.

If you have an incorporated investment banking firm engaged in the business of distributing securities, it is not within the purview of the act.

Then we go on to say any bank or insurance company is exempt, and we have to make that specific provision, because fire-insurance companies invest and reinvest in securities, as do also insurance companies and banks.

We have exempted any common trust fund as defined by the revenue act. Those common trust funds are a sort of investment trust in which trustees can participate, and they are managed by banks and trust companies.

Similarly we have exempted savings banks and small-loan associations, and so forth.

Then we have said that any company which is effectively registered with the Securities and Exchange Commission under the Public Utility Holding Company Act is exempt from this bill.

We have exempted mortgage companies, although they in essence deal in securities.

Then we have exempted oil royalties.

We have exempted all eleemosynary institutions and nonprofit associations; and we have exempted all voting trust arrangements. On those we will have a little something to say when we come to the provisions of the bill relating to voting trusts for investment companies.

We have exempted all protective committees. In addition, we have talked to some representatives of the small-loan business and the acceptance business, companies engaged in the business of buying automobile paper and refrigerator paper, and so forth. If they are engaged in the business of dealing in automobile paper and small

loans, the Commission's recommendation is that they should not be within the purview of this legislation.

However, there is one type of situation that I have in mind, and that may clarify the subject, Senator, in connection with the question you asked.

What type of securities do these companies go into who sell their certificates on the installment plan? There is a company in existence which sells a vast amount of installment certificates, those certificates that Commissioner Mathews described, where the company says that if you pay $10 a month for 12 years it will pay you $1,500. That is really an unsecured promissory note which you are buying on the installment plan. It is not collateralized in the strict sense; it is just a sort of debenture of this company.

Senator WAGNER. Does the investor know that it is just a promissory note?

Mr. SCHENKER. Well, Senator——

Senator WAGNER. You do not know that, do you?

Mr. SCHENKER. Most of the time he does not. I am not being critical in this connection, Senator, because I have personally discussed the situation very carefully with them, and they are not unconscious of the fact that these problems exist. And again, Senator, in this instance I speak with a little more authority.

The fact of the matter is, Senator, that they tell me that I am practically authorized to tell this committee that as far as they are concerned, they want legislation, because they are conscious of their obligation and feel that their type of institution which has $151,000,000 of the public's money, has outstanding contracts involving over a billion dollars and has 300,000 certificate holders, in almost every city in the nation should be regulated.

I am not saying, Senator, that they do not have some difficulties with some of our provisions. The fact of the matter is that we are still discussing it with them, and we hope to be able to work out the problem so that we can come to this committee and suggest something practical that would meet the situation and would permit these people to carry on their business.

Senator WAGNER. Of course you know that the committee is prepared to hear all of those interested in the legislation. Very good suggestions come from those that have a different slant on this question.

Mr. SCHENKER. We have discussed the bill with the representatives of small-loan companies and acceptance companies who came down to see us after the bill was published, and we are trying to work out language which will exempt that type of company, if the committee sees fit to do so, and yet not let out the type of company which sells its certificates on the installment plan, and whose portfolio consists not of certificates which correspond to those of an insurance company, but whose entire portfolio consists of automobile paper and refrigerator paper.

There is one other situation which required consideration, and we have been discussing that with the Federal Reserve Board. I refer to institutions which are known as bank holding companies. A bank holding company is a company which owns at least the majority of the outstanding stock of banks or is in a controlling position with respect to banks; and as the Senators know, under the Banking Act they have to submit to some supervision by the Federal Reserve Board if they want to be able to vote their stock.