

after that emergency blows over, to reinvest all of that money. Our study showed that such a situation has never existed up to the present time. What does our study show? We have analyzed the portfolio turn-over of a great many companies. In a sense this 150-percent ratio is arbitrary, as any percentage is arbitrary. What we tried to do was to take a big cross section of the industry and see what their portfolio turn-over was, and then on such reasonable ground to say: "If you trade above that you are a trading corporation. If you trade below that you are an investment company."

We made an analysis for the years 1936 through 1939 for 23 companies, 9 open-end companies and 14 closed-end companies.

Using the formula that we devised we found that there were only 2 companies that had a portfolio turn-over ratio of 150 percent. That percentage cannot be unreasonable, Senator, if only 2 companies out of 23 active companies exceeded that ratio.

In 1936 to 1938 there were 4 companies, and in 1937 there were 7 such companies which exceeded 100 percent. In 1939 there were only 2. So that in 1939 there were only 2 companies of the 23 which exceeded 100 percent, and our limit is 150 percent.

What is the other situation? We made an analysis for the year 1935 of 134 companies, Senator. Of these there were only 21 which had portfolio turn-over ratios of over 150 percent. That is a comparatively small number; and we say that if you have more than that turn-over you ought not to bear the label of a diversified investment company. There ought to be a disclosure that the company is a trading corporation.

Since 1935, 5 of these 21 companies have been liquidated.

Let me give you some illustrations. I will omit names. There was 1 company which had "trading corporation" in its name and its portfolio ratio for the year 1935 was 1,558.4 percent. That means it turned over its portfolio 15 times in 1 year, Senator. It bought and sold securities of an aggregate value 15 times greater than its average assets.

Then we had another company whose portfolio turn-over ratio was 1,376 percent.

Another one was 991; another was 978; and this one had the name British Type Investors. A person buying that security thought he was buying into a company which was comparable to the investment trust institutions in Great Britain; but he walked into a company which turned over its portfolio 10 times in 1 year.

Similarly, down the line until you come to the last one, which had a portfolio turn-over ratio of 154 percent.

Senator WAGNER. On the radio I have noticed that speakers often say "The index here is so and so." The average person does not know what he is talking about. I think you might help by just giving the figures, that the cash assets are so much and the sales represent so much.

Mr. SCHENKER. Assuming that a company has \$100,000,000 of assets, that means, under this formula, that he can do any one of a variety of things. He can sell \$75,000,000 of securities, or he can buy \$75,000,000 of securities in 1 year. He can sell \$50,000,000 and buy \$100,000,000. So that he can buy and sell securities in an amount equal to \$150,000,000 during that year. If he exceeds that, then he has no right to call himself a diversified investment company.

Senator WAGNER. And the assets are \$100,000,000?

Mr. SCHENKER. Yes, sir. The industry probably will say—and I am not depreciating it—“That is all right. You tell us we cannot bear the label of diversified investment company if we exceed 150 percent. But what would probably happen if there is an emergency? If I have to buy more than 150 percent I violate the law and therefore I may have committed a crime, while in the Revenue Act the only consequence is that we lose the tax preference.”

I am not unmindful of that, and I think that possibly the language of this provision requires a little more consideration. That is why we thought the industry would come in with suggestions. But I do not think there can be any compromise with the principle, Senator, that if a company is going to be a trading company it ought to be known to the public as a trading company. Is that clear?

Senator WAGNER. Yes; that is clear.

Mr. SCHENKER. Also, a diversified investment company is a company which can only have one class of securities outstanding, and it does not control or own any voting security issued by another investment company. That means a diversified investment company is a company which diversifies its investments, has a simple capital structure, is not pyramided above any other investment company and does not turn over its portfolio excessively. There is the added reservation, however, that if they feel that they can contribute capital to industry up to 15 percent of their assets, they are not subject to the provision that they cannot own more than 5 percent of the securities of corporations.

That, to our mind, at least conforms to what the popular concept and our concept of what a diversified investment company is. It should be diversified. It should be an investment. It should not be speculating. It should have a simple capital structure. It should not be pyramided on any other investment company.

Now, we go on to say that another type of company is the securities trading company. That is a company which conforms to the requirements of a diversified investment company insofar as they relate to not having more than 5 percent of its assets in another company and not more than 5 percent of the outstanding securities of an issuer.

The last classification we have is the securities finance company. If anybody feels, Senator, that his management is such that he cannot be hamstrung by limitations, the only thing he has to do is to register as a securities finance company and tell the public, “I am not limited to the extent to which I can turn over the portfolio and I am not limited as to the percentage of securities of companies I can invest in and the extent to which I can invest in a particular company.” But we say that if he wants to bear the label of a diversified investment company, and if he wants to bear the label of a securities trading corporation, then he has got to meet these basic elementary requirements. If he does not want to be subject to these restrictions, if he wants to be able to invest in any security at any time anywhere at any rate in any company in any country, he can do it, because the last clause relates to the securities finance companies.

But we do say that “In your registration statement you should tell the public what your fundamental investment policy is, so that a person can be apprised, even though you are in that broad category—securities finance companies—as to substantially what type of activity you are going to carry on. If you undertake that type of activity in

the first instance, you cannot change that fundamental activity overnight without telling your stockholders and getting their approval."

Senator WAGNER. It is 1 o'clock now, Mr. Schenker.

Mr. SCHENKER. Can we go on a little while this afternoon, if you are not getting bored?

Senator WAGNER. I think we might go on perhaps. We will take a recess until 2:30 this afternoon.

(Whereupon, at 1 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTER RECESS

The subcommittee resumed at 2:30 p. m. on the expiration of the recess.

Senator WAGNER (chairman of the subcommittee). The subcommittee will resume. You may proceed, Mr. Schenker.

FURTHER STATEMENT OF DAVID SCHENKER, COUNSEL FOR THE INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. SCHENKER. Now, Senator Wagner, in connection with diversified investment companies—

Senator WAGNER (interposing). Please keep your voice up so all may hear you.

Mr. SCHENKER. Pardon me. There is one additional aspect I would like to indicate, under the Delaware Corporation Law a company cannot redeem its own stocks unless it is a special stock. Therefore most companies which are open-end investment companies that are organized in Delaware may have to issue a small amount of common stock, a small block of common stock, so that they may issue a great number of stocks which they can sell to the public which can be redeemable. That is a technical aspect for which we have made provision in the bill.

Now, on page 11 of the bill, subsection (c) of section 5, is a provision to accommodate for this type of situation. A company may have 5 percent of its assets in the securities of one company, and then because of market appreciation in that security, and the appreciation in the remaining securities in its portfolio at a particular point of time, this original block of stock may constitute more than 5 percent of the assets of the company.

Now, that increase of percentage in the total value of the portfolio was not due to the fact that the company bought more securities, but was due to the fact that the market appreciated. And this provision, (c), has been recommended to accommodate that situation.

The company does not lose its status as a diversified investment company merely by reason of the fact that the value of its holdings increased because of market appreciation.

Otherwise you would get this situation: An investment company has \$5,000,000 of assets. Let us say the investment company has a block of portfolio securities of a single issue. Now, let me stop for a minute, let us say a block of stock worth \$50,000.

Senator WAGNER. Well, which is it?

Mr. SCHENKER. It is \$50,000.

Senator WAGNER. All right; go ahead.

Mr. SCHENKER. They bought a block of stock that gives them \$50,000. They do not violate any provision in respect to their being a diversified investment company. They do not buy another single share of that stock, but the market price of those shares goes up so that the block of stock is worth we will say \$60,000. Well, they do not lose their status as a diversified investment company even though this stock now is worth more than 5 percent of their total assets. They only lose their status as a diversified investment company by virtue of their purchasing additional securities to the extent of more than 5 percent.

Senator WAGNER. I see.

Mr. SCHENKER. Now, the next provision is (d) of section 5. You will probably hear a little about that. That is the one which says:

The Commission shall have authority—

Senator WAGNER (interposing). What page of the bill are you on?

Mr. SCHENKER. Page 11.

Senator WAGNER. You may go ahead.

Mr. SCHENKER. That section provides:

The Commission shall have authority, by rules and regulations in the public interest, or for the protection of investors, to make further classifications and subclassifications of investment companies according to organization, capital structure, nature of assets, amount of assets, investment policy, character of business done, or any one or more other characteristics which the Commission deems significant and which are consistent with the definitions contained in this section and section 4.

Now, superficially that looks like a very broad power vested in the Commission, and the language would indicate that. But there are several observations I want to make with respect to that language.

In the first place, that does not give the Commission one iota of power to impose new liabilities or obligations, or subject new classes of people, to the purview of this language. This is a reservoir of power in the Commission to relieve people.

Oh, I am sorry—I am thinking of another section. This provision here is no wise relates to any restrictions which the Commission can impose with respect to the investments the companies make.

Now, some may try to construe it that way. If the language is not clear on that point maybe it ought to be tightened up.

What this provision says is this: You take the broad reservoir of the third type of company which includes every other type of company. You may get situations where you may further want to subdivide that class so that the purpose, the activities, and the nature of the company would be made more clear to the investing public.

Let me give you a case: We talk about diversified investment companies. You take even the first class, and ordinarily in the popular mind the term "diversified investment company" connotes that they are not limited in their investments to a particular industry but that they can go into a cross-section of securities representing every type of industry in this country. But there are some investment companies which, although they comply with the provision that no more than 5 percent of their assets shall be in one corporation, and no more of that securities corporation should be owned by the investment trust, have limited their investments to special industries. You have companies which specialize in chemical stocks, and I know Mr. Eberstadt will not take umbrage at this if I use his company as an example.

The chemical fund, that means he invests substantially all his funds in chemical stocks even though he complies with the requirement that not more than 5 percent of his money shall be in one company and not more than 5 percent of one company's securities shall be owned by him.

Now, if that type of company should prove to be perhaps misleading to the investor in that that company has a general label "diversified investment company," and it really is not a broad diversified company but specializes in chemical stocks, then the Commission says, "By rules and regulations, we can create a new class in which you will call yourselves a specialized investment company."

Senator WAGNER. Would that be so if no more than 5 percent was invested in any one chemical company and no more than 5 percent of the chemical company was owned by them?

Mr. SCHENKER. That is correct.

Senator WAGNER. You would still say that that would not be, in the ordinary sense, a diversified investment company?

Mr. SCHENKER. Under the present definition, that would be classified as that.

Senator WAGNER. I mean, what would be the ground of your excluding that? Because it dealt only in chemical stocks?

Mr. SCHENKER. That is right; it is a diversified company in a single industry, but it is not diversified as to industries.

Senator WAGNER. I just wondered why that would not be diversified. There might be different chemical companies dealing in different chemicals that would be foreign to one another, as different as a steel corporation.

Mr. SCHENKER. The present bill calls them a diversified investment company. They are not excluded from the class. However, you may recognize, Senator, that at the same time you will get, as you have gotten in the past, investment companies which were diversified in different companies in one industry, as distinguished from companies in different industries, and that is the purpose of this section.

Senator WAGNER. Must they take the initiative?

Mr. SCHENKER. No; the only thing it says is that at some future time, if the Commission feels it is to the interest of the public or for the protection of investors, the Commission shall have the power to make further classifications and subclassifications.

Senator WAGNER. All right.

Mr. SCHENKER. And we say, "which the Commission deems significant and which are consistent with the definitions contained in this section and section 4."

You cannot visualize the combination of companies that may be attempted. For instance, assume that that company I told you about has automobile paper in its portfolio. If experience proves that the protection of the investor requires that that type of company bear a special label, section (d) will give the Commission the power to create that type of company, and he would have to classify as that type of company.

That is the only significance of that provision. It is not intended to tell them where to invest their money, how to invest their money, and with whom to invest their money. We say that at some future time it may be desirable, for the protection of the investors, to have a subdivision of the three primary classifications that we have at the present time. That is the significance of subsection (d).

Now, section 6 deals with exemptions and says:

The following investment companies are exempt from every provision of this title except section 7 (d).

Section 7 (d) is the section which says that an investment company, unless it is registered, cannot publicly offer securities.

Now, what companies are included within this category? First, you have a company which is not organized under the laws of the United States or of a State. That means that a foreign corporation has got a complete exemption except that he cannot sell his securities in this country.

Now, we had to take that approach, Senator, because you may have a foreign corporation which has not sold securities in this country, yet wants to buy securities on the New York Stock Exchange. We say that a foreign investment trust, although it has not any securities in this country, should not be deprived of the use of the New York Stock Exchange and New York Curb.

You may ask, Why don't you let foreign corporations register? We do not permit foreign corporations to register in this bill. The answer to that is that he may register. As a foreign corporation, he would not have any jurisdiction over him, so he will get the benefit of being a registered company, which may or may not help him in his sales talk up in Canada, and yet not be subject to the provisions of this bill. So we say, with respect to foreign investment companies, you are exempt from the provisions of this act, you cannot sell your securities in this country, and you cannot be a registered investment company under this bill.

Now, paragraph (2) exempts an investment company which is organized under the laws of, and having its principal office and place of business in, Alaska, Hawaii, Puerto Rico, the Philippine Islands, the Canal Zone, the Virgin Islands, et cetera. That is a similar problem. It is not that you do not have jurisdiction over them; they are so distant from America that the policing aspects are quite difficult. We have that problem in connection with exchanges in these islands, and so forth.

It says you are exempt. However, you are not exempt if you try publicly to sell your securities in this country. As long as you limit the sale of your securities to these territories, then you are exempt. If you want to sell your securities in the United States, then you have to register.

Now, the third paragraph exempts companies which at the time of the enactment of this legislation, if it be enacted, are in receivership. Those companies are exempt. However, if they go into receivership after enactment of the title, then the Commission has some jurisdiction with respect to them.

Now, subsection (d) on page 13 makes provision to grant the Commission power to exempt employee securities companies. Now, these employee securities companies exist in great variation. You have got the type of employees securities company which is virtually an eleemosynary institution, which the investment company sets up as a sort of savings plan for his employees; and, on the other hand, you may have a situation like the Hobson Employees Co., which was not so eleemosynary—at least, from the point of view of the employees.

Now, the only way you can deal with that problem is by making an application with the Commission and the Commission studying

the situation. If it feels that it is of the character of category A, then the Commission is empowered to exempt it either fully or under conditions, or to impose upon it such conditions as the Commission feels necessary in the public interest or for the protection of the investor.

Now, we come to provision of subsection (c), and that is the one I started to discuss a little bit before. That one says:

The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that the Commission finds such exemption necessary or appropriate in the public interest and consistent with the protection of investors.

That is the one that has this awful broad sound. As I started to say before, this is the section which gives the Commission power not to impose any new obligations or liabilities but to exclude either transactions or persons or classes of securities, from the umbra of the bill.

Frankly, Senator—and I have heard some rumblings about this section—I cannot understand the difficulty with it. Now, you will probably hear some discussion about the technical nature of this business and about the difficulty of making provisions for regulating an industry which has so many variants and so many different types of activities, and it is precisely to meet that sort of argument that this provision is inserted.

You cannot possibly anticipate a transaction which you feel should not come within any specific provision of this bill, and you cannot possibly anticipate any person who may or may not come within the specific provisions of this bill.

Now, the fact of the matter is that, in connection with the passage of the Securities and Exchange Act of 1934—and I remember it quite distinctly—Richard Whitney for hours talked at the public hearings on the bill and insisted that the Commission take that power. He said, "Why do you want to hamstring yourselves? You cannot possibly anticipate things that may happen. If you run across a situation that you feel is not within the purview of any particular provision, you will be able to exempt it."

As Judge Healy said in his opening statement, the very first problem that the Commission had was the registration of thousands of securities on the exchanges and the regulation of all the exchanges. It had to be done in a short period of time. If it were not for the fact that the Commission had the power to exempt those that were registered at the time for a period of 60 days, it would have been in difficulty. What they did was that anyone who as presently registered on the exchange was exempted from the provisions of the bill for 60 days, and that gave us 60 days to work out the exemptions of the bill.

If you are going to look for bugaboos, you probably can find them, but this is written to meet those which are not anticipatory. This says not that we can go out and bring new people under the act, not that we can impose new obligations. The only thing that this provision says is—if conditions exist or arise which manifestly are not within the legislative intent of this legislation, then the Commission should be in a position to exempt those in that situation, and the industry should not be required to go to Congress to get a statutory enactment to meet that specific situation.

Now, subsection (d) implements subsections (b) and (c). As I understand it, Senator, in connection with the Holding Company Act, there were certain situations where an industrial corporation owned its own generating plant. I am giving you this example as a hypothetical situation. Now, the Commission did not want the company which owned the generating plant to file an elaborate registration statement, just because it was a holding company. Yet it found itself in the position where it could not exempt the holding company completely. It did not want to exempt it completely; yet it could not subject the holding company to provisions of the act without the holding company first registering. That is the way that statute was written. The Commission could only grant exemptions to a registered holding company, so you had to register in the first instance before it could exempt you from the provisions.

What we are saying here is that if a situation like that exists we do not want that company to register. Yet we feel that it should be subject to some provisions of the bill. For instance, if the Commission felt that the employees' securities companies should not be required to register, it could say, "This company does not have to be registered provided there is no dealing between the company and the investment company; that is, the employer corporation shall not sell any securities directly to the employee corporation."

Under this section, provision is made that the company is not required to be registered in order to subject it to specific provisions; and, conversely, it could relieve it from all provisions, including registration, and just subject it to those which they thought were particularly applicable to that company.

Now, section 7 is the section which is really the heart of the legislation, in that it says that no investment company, unless it is exempt or unless it is registered, can use the mails or an instrumentality of interstate commerce. An instrumentality of interstate commerce includes the facilities of the securities exchange to sell portfolio securities or its own securities, to buy other securities, or buy back its own securities.

An investment company, unless it is registered or exempt, cannot engage in any business in interstate commerce and it cannot control any company which is engaged in interstate commerce or uses the mails or any instrumentality of interstate commerce.

Now, subsection (b) is a similar provision for the people who are connected with fixed trusts.

Subsection (c), on page 16, says that no promoter of a proposed investment trust shall use the means of interstate commerce to sell preorganization certificates. That is a technical problem, Senator, which becomes quite important in connection with this legislation, because we say that no investment company can be registered with us unless it has got at least \$100,000 of assets. That means he would have to raise \$100,000 among his friends or by private offering. If he could raise the \$100,000 in the preorganization stage by a public offering, then we are not accomplishing anything. This subsection is to insure that the moneys raised in the preorganization stage shall be by private offering, rather than public offering.