

repurchases from "insiders"—repurchases of their own securities—and sales of portfolio securities by "insiders" to investment companies; and in every case it tends to show a heavy concentration in the months of October, November, and December of 1929 and 1930. Now, that is a general statistical proof that these fellows go back to their investment companies when they need money. I do not say all those transactions are improper, but I say that a lot of them are very questionable.

You will notice that in dealing with this we have not at this time advocated complete segregation. Senator Taft was speaking about banks. My understanding is that investment bankers cannot be on the board of banks. Is that correct, sir? It is my understanding.

Senator TAFT. Yes; I have no objection up through (d) here. I have not read (e).

Mr. SMITH. Well, Senator, in 10 (d) we say that the same principles shall be carried down to the operating level, that the officer who is doing the actual determination of the decisions for purchasing and buying securities shall be independent, too, and shall not be one of these people who is receiving money out of the investment company in various ways, other than just its management.

Senator TAFT. What is the reason for the (c) provision, if they cannot?

Mr. SMITH. No, I am not there yet.

Senator TAFT. Oh, you have not yet gotten there.

Mr. SMITH. May I come back to that in just a moment, sir?

Senator TAFT. Yes; go ahead.

Mr. SMITH. In 10 (d) I want to point out one rather important investment company that illustrates the investment officer type of problem. There is a resolution from their minutes. It said:

Resolved, That the authority conferred upon the president or either of the vice presidents to make purchases of securities for the account of the corporation up to the amount of \$150,000 be and the same is hereby amended to increase that amount from \$150,000 to \$500,000.

Resolved—and so forth, in another resolution giving the same authority to the president and vice president to give loans up to \$500,000 instead of \$150,000.

That is why I say a lot of these investment companies have a board of directors that meets every 2 or 3 weeks, if it does meet then, and they have an operating group that may consist of an investment committee or a single operating officer—like the man in Boston about whom I was speaking; he was the kingpin.

So we make the same principle apply down at the operating level as with respect to the board.

Senator TAFT. Going back to (c) what is the reason that no director of one investment trust shall be the director of another?

Mr. SMITH. If he is an investment banker or broker.

Senator TAFT. Oh.

Mr. SMITH. I can show you some instances where investment bankers in 1929 were affiliated with four or five different investment trusts; and you will find that in one case in a fairly high-class firm; there was a 68-percent overlap with the other investment companies in the portfolio; and the portfolios are saturated with instances in which they are interested with investment bankers.

So we say the number affiliated with one investment company and not a lot of them, in order to avoid it.

Senator WAGNER. Mr. Smith, I was just going to try to qualify you as an expert. [Laughter.]

Mr. SMITH. Yes.

Senator WAGNER. As I understand it, you do manage trust funds now; do you not?

Mr. SMITH. I have been doing so since 1931.

Senator WAGNER. You have been managing trust funds of some size?

Mr. SMITH. That is right.

Senator TAFT. There is no overlapping prohibition against someone's being in the Securities and Exchange Commission and also managing investment trust funds?

Mr. SMITH. Maybe there should be. [Laughter.]

But I may say, from my personal point of view, I am interested in seeing this industry grow and not decrease, because I think it serves a very useful function.

Senator TAFT. That is so with all of us.

Mr. SMITH. But I cannot see how they can serve a useful function until they get cleaned up and stop trying to make their personal interests in the business of the company.

Senator HUGHES. May I interrupt you?

Mr. SMITH. Yes, sir.

Senator HUGHES. Do you see any means of cleaning it up, as you call it, except by regulation? The question arose this morning, and I have had some suggestion of the discussion as to whether some other plan might be adopted, other than regulation—that is to say, a statute forbidding certain practices; instead of regulating the company, simply shut it off so it could not any longer, without committing a crime, continue that sort of practice.

Mr. SMITH. Well, sir, we have as far as possible attempted here to put specific prohibitions into the statute, as opposed to leaving any flexibilities. I do not say we have done it every place, but I think you will find where we have not done it we have done it for the benefit of the industry; but I am in favor of as little administrative power as possible.

I might say the whole section 10 could be greatly cut down if you decide to segregate investment banks and brokers. I am not convinced that they should be segregated; but in view of the fact that 50 percent of the industry is sponsored by investment bankers and brokers, our recommendation has been this, instead of complete segregation which a great many people have recommended in our hearings.

Senator WAGNER. Which is much more drastic.

Mr. SMITH. Yes, sir; much more drastic.

Senator WAGNER. Yes, sir.

Mr. SMITH. In that respect I can show you various people in the industry who have appeared in our hearings, and otherwise, who have advocated complete segregation of the investment banker and commercial banks from investment companies; so that the position we take is a middle-road one between no regulation and complete segregation.

Senator TAFT. Yes.

Mr. SMITH. I do not know whether it is enough; I have doubts whether we should not go further. That is the only question I have.

Senator TAFT. But there is a question as to whether there is

certainly an advantage in having on the board a man who knows the business, if you can get rid of the personal conflict.

Mr. SMITH. That is right. On the other hand, sir, I do not think that the investment bankers or brokers have particularly shown their qualifications as managers. For instance, the investors' experience—

Senator TAFT. You are allowing only one director in a bunch of directors.

Mr. SMITH. That is right. I was going to say that, while in managing funds they have managed them about as well and no better than anybody else—that is, managing the funds after they got them—the investors' experience with funds run by investment bankers and brokers is the worst of all.

Senator HUGHES. What is that?

Mr. SMITH. I say the investors' experience. The experience of investors who put their money into banks operated by investment bankers and brokers is worse than any other group; and that is based on the observation of 82 companies.

Senator TAFT. And also based on the 1929 fiasco, when many of the people who went into those companies went into them as gamblers and knew they were gambling.

Mr. SMITH. Yes; but I think the investment bankers must have the responsibility for that; because they sold over \$3,000,000 to the American public under those conditions.

Senator HUGHES. And on overloaned collateral.

Mr. SMITH. Yes.

Senator WAGNER. In these securities these stockholders do not have voting power, do they? Is not that controlled?

Mr. SMITH. That is another thing; we shall come to the devices for putting up very little money and getting the public's money and controlling. In that respect I would say the investment bankers must also share the responsibility; because I can show you company after company which has a complicated set-up which achieves that result and which from my point of view is undesirable.

Senator WAGNER. That is definitely a device, is it not?

Mr. SMITH. I think so.

Senator TAFT. What is the meaning of subsection (e) now?

Mr. SMITH. Now coming to (e), that is to prevent an investment company's having a director on the board of an industrial company which it owns in its portfolio: If it has a director on the board, there is always a problem as to whom he owes the duty. Does he owe it to the investment company or to the industrial company? I can give you an example of one of our leading companies, which is run by investment bankers, by the way, and which turned over in 1929 its commitment to take up some stock in a packing company. That investment company took up that stock, and had a \$300,000 or \$400,000 interest in the packing company. A banking firm also had a substantial interest of its own, and they had two directors on the board, interlocking directorates. Because the investment company was completely dominated by the banking firm and had nine members of the board, those were the only members of the board. Now, these two directors were both on the packing company and on the investment company, and sat on that company's board while it went steadily down, down, down, down; and finally in 1932, after some more money had been put up, it went into receivership. I questioned this director

who sat on both boards; I said, "How could you possibly sell the securities of that company? You are a director and you owed an obligation to that company."

He said, "Oh, well, we would have done it."

Senator TAFT. I do not understand; I do not see that clearly.

Mr. SMITH. The investment company had interlocking directorates with this industrial company.

Senator TAFT. I understand that.

Mr. SMITH. And the investment company had a substantial investment in the stock of this industrial company, and also the banking firm; and they had interlocking directorates.

Senator TAFT. Do you mean the banking firm also had stock in the industrial company?

Mr. SMITH. Yes, that is right; they also had stock in the industrial company; but they had also done some underwriting for it, so there is a further mixture of interests.

This packing company went from bad to worse. Some people think the handwriting was on the wall.

Senator TAFT. Of course, many people held on to stocks when they went on down.

Mr. SMITH. That is correct.

Senator TAFT. I mean is there the suggestion that they concealed the condition of the industrial company?

Mr. SMITH. Oh, no; I am not questioning their integrity. I am just saying that having a director on the board in that case, he admitted, did not do the industrial company any good at all, and he admitted some of the conflicting loyalties that he owed to the industrial company and to the investment company.

Senator TAFT. Because a man sitting like that as a director would ordinarily pass on all the investments of the investment trust and also would keep them advised, of course.

Mr. SCHENKER. Senator Taft, may I give you an example with respect to this section?

Senator TAFT. First I should like to understand what you provide here. You are providing that it shall be unlawful for any director or officer of an investment company to serve as a director of an issuer of an outstanding security, that is, of an industrial company?

Mr. SMITH. That is right.

Senator TAFT (continuing). If the investment company owns less than 5 percent of the outstanding voting securities.

Why "less than five"? Why not more than five?

Mr. SMITH. Now, sir, in that respect we have said that if an investment company is going to hold less than 5 percent, it should be in a critical position. It should not be involved in the management of that company, but should be the investor and should look at that company from the investor's point of view and should have one hand in and out.

If it holds more than 5 percent, then we are drawing that arbitrary line—and there may be some other point where you should draw it: Then we have said that you can have a director but that director should not be an investment banker or broker.

Because when you hold more than 5 percent, or any large block of stock, and your investor is an investment banker or broker, you have all the danger of the use of an investment company for their purposes.

Senator TAFT. I do not understand. If you own but 6 percent of the stock of a company, then you can have a man on your board who runs that company; but if you own less than 5 percent, you cannot?

Mr. SCHENKER. Senator, perhaps I can explain it.

Senator TAFT. Yes.

Mr. SCHENKER. You were not present when we discussed the different types of companies. One type of company is called the diversified investment company, and that company invested in diversified securities without any attempt to exercise any control or influence in the portfolio of the corporation.

The other type of company is the company which says, "My business is to buy big blocks of stocks and participate in the portfolio"—like the Atlas, the Phoenix, or like the Continental, in Ohio.

We say that if the type of company is the diversified investment company which is limited to holding not more than 5 percent of the outstanding, he should be in the position of a critical investor, without any obligation to the portfolio corporation, which he may have if he is a member of the portfolio corporation.

Senator TAFT. The result is that unless they happen to be one of these big operating ones, no investment company could have as a director or officer any director or officer of a stock listed on the New York Stock Exchange?

Mr. SCHENKER. That is correct, sir.

Senator TAFT. Is not that rather an extreme viewpoint? I mean the first few provisions seem to be based on the theory that if you have an independent manager you are all right.

Now, you come along and say, "You shall not have even one man"—a General Electric officer; Mr. Swope, perhaps—"on the board of an investment trust if you are ever going to invest in any investment securities except more than 5 percent."

Of course, it is unlikely that you could.

Mr. SMITH. This is from the manager of a company that raised \$7,000,000 and had about \$1,900,000 left on April 30, 1932. He sold the company out:

I was anxious to find some way to improve the position of the stockholders and I had made up my mind that under our set-up we could not operate as efficiently as under a set-up where there was one man in control. My experience and observation has been that it is very difficult to get half a dozen men to agree at the right time to purchase or sell securities where each one has practically equal authority in your corporation. If I would suggest I thought it was time to liquidate they would say, "Yes; we think you are right. Conditions don't look very good." "Well, what will we sell?" Then we would go on down the list, and my experience was each director seemed to have some company and he said, "The others can go down, but this is going to stay because I know all about it and we won't sell it." So it became a very difficult and unwieldy problem to manage it.

Now, Senator, this interlocking director about whom I told you before said that in 1 year they had four complaints about the investment company selling their stock, that he as a director should have prevented the investment company from selling the stock of the company of which he was a director, and he was an interlocking director.

It may be that this first provision, section (e) (1), needs some rubber in it. I do not know, but I think I have tried to make clear the principle of it.

Senator TAFT. And section No. (2)?

Mr. SMITH. Section No. (2) is directed at the investment banker.

Senator TAFT. That would apply only where the man occupied three positions, really—as an investment banker, as an industrial director, and as an investment-trust director?

Mr. SMITH. That is right.

Senator TAFT. So that is not such a prohibitory one. No. (1) is the more restricted?

Mr. SCHENKER. Senator Taft, may I give you an illustration—and I am going to use the name of the company, because the witness testified and practically said we could use his name.

You take the Central Illinois Bank, of Chicago. That was the Dawes bank, and Henry Dawes graciously came down and testified, as did Mr. Philip Clarke, who was the president at that time. They had the interlocking situation of the officers and directors of the bank appointed officers and directors of their investment trust. What happened? The bank stock was declining. The officers and directors of the bank, who were also the officers and directors of the investment trust, used the investment funds to try to stabilize the bank stock because they were afraid of a run. Here was Mr. Clarke on the board of directors of the bank and on the board of directors of the investment company; and, as I said, to Mr. Clarke, “Mr. Clarke, when you were there with the finest inside information in the world, you were on the board of directors of the bank and you know that application had been made to the Reconstruction Finance Corporation for \$90,000,000, and yet you permitted your investment company to stay with a block of stock of the bank of \$2,000,000, with the possibility of assessment for double liability?”

He said, “Mr. Schenker, I could not open my mouth. I could not tell the investment trust to get out of that block of stock. And if I suggested that the investment trust liquidate the bank stock, that would have accentuated the difficulty to the bank and the possible danger to the trust, and I had to sit there and eventually permit them to lose \$2,000,000.”

Senator TAFT. It is exactly what an outsider would have done? The difficulty of which you are complaining is not that, but that the majority of the whole trust is controlled by the bank?

Mr. SCHENKER. That is right.

Senator TAFT. You are stating a case here where you are prohibiting even one director, the stock of whose company may be owned in part in a long portfolio of an investment company.

Mr. SCHENKER. That is correct, Senator.

Senator TAFT. I mean I do not see, in the particular case you cite, where they were any worse off by having Clarke on the board; and in many other cases he may have known many things about other Chicago companies which would have been most valuable to the investment trust and where he would not have been limited.

Mr. SCHENKER. That is right; but if the investment trust had not been affiliated with the bank and had that information, there would have been nothing to prevent them from selling the stock; but because Philip Clarke was a director of the bank, he could not make that suggestion.

Senator TAFT. It would not have been of any use in that situation, but would it have been of any particular harm?

Senator WAGNER. The entire amount was lost?

Mr. SCHENKER. Yes, the entire amount.

Senator WAGNER. If he had not been on the board, he could have prevented their losing part of the stock?

Senator TAFT. If he had been some outsider, he could not have made the suggestion to keep them from losing the stock because he would not have known.

Senator WAGNER. That may be; but I would think it would be better if the entire board were free of any kind of influence from bankers; because I think you can get other men. Of course, I know that is ideal and that we are not going to get that far; but then there would be no chance about their loyalty being consciously or subconsciously only to their investment trust rather than to outside interests.

Mr. HEALY. Does it not come down to the question of what the basic philosophy of the investment trust shall be? That is, shall the diversified trust which goes into diversified industries and invests small amounts in each one take any responsibility for the management of the companies in which it invests or shall it take a stand-off, critical position of those investments?

Senator TAFT. Look at it in another way: I happen to know of the trust fund of the Cincinnati Institute of Fine Arts. We want to get the best executive committee to invest. Whom do we get? We get the president of one bank in Cincinnati and we get the president of another bank, and we get the vice president of Procter & Gamble Co.—why? Because we think those men will know more about what we should invest in than anyone else. That is the only way in which an investment trust would be run. So you have a balance of desirability; and up to (d) I have no criticism of it. I question a little bit (d) (1); it seems to me that may be going a little far.

Mr. HEALY. May I add a word to what I was saying? When you get out of diversification which I mentioned and you get an investment trust owning a portion of the underlying portfolio of the corporation, above a certain amount, then this does not apply.

Senator TAFT. Although the question of dishonesty then becomes of much greater weight than in just under 5 percent.

Mr. HEALY. Yes; but in that kind of position it can be argued that the company is taking responsibility to some extent at least for the management of the corporation in which it invests.

Senator WAGNER. I still say there should be complete separation, and that in the long run it will serve the better purpose. However——

Mr. SMITH. I shall run quickly over these other sections, Senator.

Senator WAGNER. All right.

Mr. SMITH. Now, Senator, (f) is to take care of the investment-banker situation. If they have more than one-half of 1 percent in the portfolio of the investment company, then an affiliated person cannot do the underwriting. That is to prevent the investment trust's being used, so to speak, as a bird dog for the investment banker; and we have various cases where the investment trust was used to get brokerage or all the other emoluments that the investment broker looks for or, once he has them, it may be used to put them in cold storage for him. I can give you other illustrations of companies affiliated with investment bankers, where 30 percent or 40 percent of the portfolio has been securities which they have underwritten; and there is one investment company today which has run and has a pretty good record with investment bankers. But I have questions about it, myself—not as to the integrity but as to the policy. When they are in less than one-half of 1 percent situations, of course, that is different.