I think it could be demonstrated that, on the whole, this power of the Commission, an administrative body that more or less specializes in this field, to see that the investor gets justice, more than offsets any delay. As a matter of fact, in the recent Utility Power & Light reorganization, Judge Holley out in Chicago appointed a special master who sat with our trial examiner, and it shortened the whole process.

It is my contention that instead of our participation resulting in delays, I think it shortened the whole process.

I do not feel too strongly about this, and of course it is entirely in the hands of the committee. If you see fit to take away from us completely the power of making a finding as to whether a plan is fair and equitable, and so on, then I suggest that perhaps you would be willing to allow us to write an advisory report which would be submitted to the court and the security holders. We think that an impartial body which has no money stake whatever in the result can step in and analyze one of these difficult situations and be quite helpful. In a great many cases the security holder does not know whom to believe. He gets all sorts of conflicting statements as to what the plan is and what it means, and so on. We will make mistakes, of course, in some of our analyses, but on the average our analysis would be much more reliable and understandable than that presented by somebody who has a money stake in it. I am not sure that the work which the Commission is doing under the Chandler Act is not the most useful of its functions right now.

Senator HERRING. Under that act, of course, you merely recommend. Under this you prohibit.

Mr. HEALY. That is true.

Senator HERRING. There is quite a difference.

Mr. HEALY. Yes.

Mr. SCHENKER. May I say one word there, Senator?

Senator HERRING. Certainly.

Mr. SCHENKER. The type of situation you are talking about and that Judge Healy was discussing is the type of situation where a petition under 77B of the Bankruptcy Act is filed in court. Under those circumstances the Chandler Act says that the Commission should study the situation and file an advisory report with the court. However, the situation with which this section deals is where there is no petition under 77B filed.

I am not being critical in this. You take the whole plan of the merger between Curtiss Wright Corporation and the Atlas Corporation, that is, the exchange offer. The fact of the matter is that the Atlas Corporation, through exchange offers, without a court to pass on the exchange offers in a single one of the instances, absorbed 21 investment trusts by this voluntary reorganization procedure, rather than by involuntary reorganization where petition would be filed under section 77B and a court would supervise it.

Also The Equity Corporation absorbed many investment trusts. No court had any supervision over the exchange offers. That was an entirely voluntary situation.

We have hundreds of letters admitting that there ought to be some independent agency to examine these offers to see whether they are not an imposition upon the investor.

These voluntary exchange offers where corporation A makes an offer to exchange its securities for the securities of another investment

company, do not pass before any court, Senator. Today nobody has any jurisdiction to look at such exchange offers, to approve it, or even to write an advisory report in connection with it.

Senator HERRING. I am not complaining of the effect you are aiming at. The question is only about the method. That is the point.

Mr. SCHENKER. Then your suggestion is, Senator, or your present reaction is, at least, in this type of situation, to say: "Why do you not use the same type of procedure used in 77B and send out an advisory opinion to stockholders suggesting that the exchange offer is fair or unfair, and let them make up their own minds?"

That is one approach to it. I will not assume to speak for Judge Healy, but I have the feeling that possibly he feels that may be sufficient.

However, I conducted the examinations on the Equity Corporation and the Atlas Corporation, and I found this situation. Usually the persons who are interested in effecting the exchange offer have sufficient voting power to push it over, and therefore that leaves the minority stockholder in this position: Unless he is conscious of his legal rights, without his consent and without his volition he can be made a stockholder in another investment company. It is that group of people who are not even remotely conscious of what their legal rights are under the circumstances, and because of the small size of their holdings cannot afford to go out and get lawyers or investment counsel to apprise them of their rights who are virtually powerless. You may tell them it is unfair, and they may agree that it is unfair, but there is nothing they can do about it, because the people who are interested—and they may have some ulterior motive and they may not—in seeing that the exchange offer is effected, usually control the offer.

We have set forth in a 600-page report the devices they use. They pay commissions to the officers and directors of the companies of which they want to get control, to write letters to the stockholders. You can see the situation. The S. E. C. will say it is unfair, but they get people upon whom the investor has some reliance, and he says just don't pay any attention to that.

Mr. HEALEY. I wonder if it would go any distance toward meeting your point, Senator, if this were rewritten, so that when the reorganization is before the court, we might write only an advisory report and not have the power to approve or disapprove.

Senator HERRING. Yes.

Mr. HEALY. But where the reorganization or exchange is being put through out of court, and there is not any governmental body with authority in the matter, in that kind of a situation the power of the commission might be more than merely to advise but to approve or disapprove, pursuant, of course, to a rule of law laid down in the statute.

Senator HERRING. Because, if we have any chance of passing legislation of this kind, we have got to do everything we can to allay fear and misapprehension. That is why I brought the question up.

May I ask, Senator Hughes, if you are going to meet this afternoon?

Senator HUGHES (presiding). We will try to meet again at half past 2.

Senator HERRING. I would like to go over to the floor of the Senate. There are some things coming up over there in which I am very much interested.

Mr. HEALY. I would like to further consider what you have said, Senator, and perhaps we can discuss it further.

Senator HERRING. Yes.

(Senator Herring withdrew from the committee room.)

Senator HUGHES (presiding). I think we might go on until 1 o'clock, and then take a recess until half past 2 this afternoon.

Mr. HOLLANDS. I will go right on with section 26, Senator, because if there is to be any further discussion of section 25 I think Senator Herring would like to be present.

Senator HUGHES. All right.

Mr. HOLLANDS. Section 26 deals with what are called unit investment trusts in this bill. They are commonly known in this country as fixed trusts, and in some cases as semifixed trusts.

You will recall that Mr. Schenker told you the other day what developed in connection with those trusts. They came into life and were most active particularly after the stock-market crash, when there was not too much faith in the management type of trust. They are not a very large factor today, although there are still some of them, and they may start up again later.

There are two principal problems which I will mention in this connection, without taking up all the provisions in detail.

The first problem is to prevent a trust's becoming what is called an orphan trust. This may happen when a sponsor actively sells securities of the trust and finds that he cannot sell any more and so virtually goes out of business, or organizes another and ties up with another trust in some way. The trustee of course could still carry it on, but sometimes no provision is made to remunerate the trustee, and since he has no possibility of remuneration out of the funds of the trust, he just sticks the stuff in a safe-deposit vault and lets it sit there.

There are several provisions in here to make sure that the trust will not become an orphan, and that the depositor will not sell his depositorship, which is a problem similar to that of a manager selling a managing contract. In addition there is a provision that when a trust has become an orphan and no one has taken steps to liquidate it, the Commission may file a complaint in the district court and seek to have it liquidated. The Commission, in effect, would be an amicus curiae in that case to see that there is a dissolution.

Senator HUGHES. Is there any place in the bill—if there is, I do not recall seeing it—where there is a definition of a unit investment trust?

Mr. HOLLANDS. Yes, sir; in paragraph (2) of section 4 on page 9.

Senator HUGHES. Proceed.

Mr. HOLLANDS. The essential distinction between these trusts and the management trusts is that these trusts have virtually no management. The investor really exercises his own judgment, because he is ordinarily shown the list of securities in which his funds will be invested, and it is only under very special circumstances that the portfolio can be changed and those securities eliminated and others substituted.

I may say that I think it is obvious that many of the earlier provisions we have been discussing simply did not apply to those com-

panies. Those provisions have been made applicable to management investment companies and in most instances have been expressed as being applicable only to management investment companies.

Mr. SCHENKER. Section 27 of the bill deals with installment investment plans. These plans are devices whereby they sell an investment trust on the installment plan. The section provides, first, that the sales load shall not be more than 9 percent. Provision is then made to insure that this 9-percent load is not taken out of the first few payments but is equitably distributed over the life of the contract, so that if a person defaults or surrenders his certificate in the early stages of his contract, he will not lose all his money.

We also have the provision that the payments should not be less than $10 a month, and that the first two payments should be $20 each. That is in conformity with the suggestion of the industry that such a provision be incorporated.

The reason for requiring a $20 payment for the first two payments is that you will at least not sell a certificate to a fellow who has not got $20 for the first payment and $20 for the second payment. They tell me that sometimes $5 will make a difference between a sale or no sale. If a fellow had to put up $15 instead of $10 they could not make the sale. That is how short a margin the prospective investors have. And this will have the effect of cutting out sales to miners, policemen, nursemaids, and servant girls, and get to the professional people, the small-business men, who can afford to do it.

The next provision says that the certificate holder shall have the right to his value of the securities; and paragraph (2) says that the securities and the proceeds of the sale must be in the custody of a trust company or a bank.

Subsection (c) has a provision to insure that there will be a trustee in the picture and that he cannot resign unless a substitute trustee is provided for.

Section 28 deals with face-amount certificate companies. Those are the companies that Commissioner Mathews spoke about, which sell unsecured promissory notes on the installment plan. With respect to that type of company we say they cannot start doing business unless they have $250,000 of assets, which is the figure usually provided for insurance companies by State laws.

Then we make provision for these types of situations: We provide that those who want to get out of the plan do not take too substantial a loss in the early years of the contract. We make provision requiring the companies to create reserves which will insure that they can fulfill their contracts if the investors keep making the payments until maturity. And then, in order to get away from that type of company which has automobile paper, or may have commodities, we say that the type of investment the companies should make, at least with respect to their reserves, should be the type of investments made by life-insurance companies.

We also make provision that the reserves can be required to be deposited with a trustee.

Paragraph (d) is the provision relating to surrender value:

Paragraph (e) says that the person who buys one of these certificates on the installment plan shall not be liable for the unpaid balance. If he makes 10 payments and wants to quit, then he is not liable for the balance of the payments. That is the situation at the present time.

Senator HUGHES. If he wants to quit, he can withdraw what he has paid in?

Mr. SCHENKER. That is right; and they cannot sue him for the balance.

Paragraph (f) deals with this situation: Suppose you buy one of these certificates on the installment plan and make regular monthly payments for 9 years and then you default on one $10 payment. They stop the running of interest on all the money you have paid in. So this provision is to eliminate that sort of thing, and to make some equitable provision that he gets interest on the amount that he has already paid in.

Section 29 deals with this situation: Some of the States today require that the company deposit with the securities commissioner securities or assets sufficient to cover the surrender value of the certificates sold in that particular State. There is some question whether that type of provision is effective in order to accomplish the purpose which is sought to be accomplished—namely, to protect the certificate holders in that particular State. You get this problem, however. One State requires more than is necessary. Some States do not require enough. There is a great diversity of amounts of deposits. What would happen if the company should go into bankruptcy? Then you would have the situations first, are these deposits sufficient to give the certificate holder a preference with respect to these particular assets? Secondly, you would meet the problem that because of some fortuitous circumstance, or because one security commissioner was more alert than another, the security holder who happens to live in one State will get all his money, and the security holder who lives in another State will not get his money.

We do not disturb the present deposits and the situation with respect to future payments made on outstanding contracts. We do say that with respect to future contracts, if the company goes into bankruptcy, then any deposits which have been required by the State security commissioner for those future sales should have no effect, and all the certificate holders, regardless of what State they live in, should share equally in the assets.

Senator HUGHES. Do they have laws of that kind in some of the States dealing with investment companies?

Mr. SCHENKER. Only with this type of company, Senator. This is the company that sells unsecured promissory notes on the installment plan.

Mr. HOLLANDS. Section 30, Senator Hughes, contains what are substantially the usual requirements in statutes which the Commission is now administering, for annual and other periodic reports and certain special reports to keep up to date the information that is filed in the basic registration statement.

I might point out specifically that subsection (b) of section 30 requires the Commission to integrate the reporting under this bill and under the Securities Exchange Act of 1934, so that the companies can file one copy and one report and satisfy both acts.

Subsection (c) is a very important provision. There is no provision to that precise effect in the Commission's existing statutes. It says, in effect, that the Commission can require registered companies to send reports to their shareholders which shall contain such of the information contained in the company's reports to the Commission

as the Commission specifies. The report can also contain other information. The section sets a minimum there, but it does not set a maximum.

The purpose of the provision is to make it possible for the Commission to make all investment companies conform to the present practices of the more reputable companies.

Senator HUGHES. I suppose when we hear the opposition to the bill, one principal point will be the difficulty of making these statements and the cost and expense of them, and all that kind of thing. It always is.

Mr. HOLLANDS. A great majority of companies already send reports to stockholders. I do not think that there would be much difficulty in tying those reports into the reports they file with the Commission.

Senator HUGHES. I suspect the information is meager, like most of the reports that companies send to their stockholders.

Mr. HEALY. I think it may be said that the real source of this particular provision in the bill grows out of experiences we have had under the Securities Act, where we analyzed a number of the annual reports that the corporations were sending to their stockholders, and found that there were variations and inconsistencies between the reports filed under oath, under the Securities Act, and those which were sent to the stockholders with the annual report. What we are trying to get at here is to really get rid of that kind of thing. I do not think the industry will find any fault with that general principle, although they may find fault, and perhaps with some justice, with the provision that we might ask that the reports be made too often, or something of that sort.

Mr. SCHENKER. In that connection, Senator, that is the value of the provision which gives the Commission the power to classify companies. We can say a small company shall only send out reports semiannually; that a big company shall send them quarterly. Also it indicates the value of the exempting provisions. We can say that a small company shall not be subject to these rules.

Mr. HOLLANDS. Subsection (d) makes the beneficial holders of more than 10 percent of the outstanding securities of investment companies, and the officers and directors of such companies, subject to what are substantially the reporting requirements and the liability provision of section 16 of the Securities Exchange Act of 1934.

In other words, the purpose of this subjection is to make all registered investment companies subject to the same provisions regarding trading by insiders in the company's securities that the listed companies are now subject to.

I may say in that connection that the drafting of subsection (d) is defective and needs a lot of patching.

Subsection (e) deals with another problem that is peculiar to investment companies. You may have a case of officers, directors, or other insiders trading to their own advantage and to the detriment of the trust, not in the securities which the trust itself issues, but in portfolio securities of the trust.

That is not a matter that is probably of terrifically frequent occurrence, although it can be very bad when it does happen. It is also a very delicate matter to deal with. We are attempting here to reach a compromise between the various considerations by making this provision. The insider is required to report to the board of

directors of the company—and this applies only to management companies in any case—all purchases and sales which he has made during the past fiscal quarter, of securities held in the portfolio of the company; that is, securities of the same issuers. The report does not have to be made until 30 days after the end of the quarter. It is made only quarterly and is made only to the board of directors of the company, not to the Commission, to insure privacy. The practical effect of that should be that there would be no serious abuses in trading against the trust, because the person has got to disclose it to the directors.

Mr. SCHENKER. On that aspect, Senator, we have a great many instances where officers and directors will trade in the securities or buy securities a little before the investment trust does, so that the insider is getting a free ride on the purchases of the stock by the investment trust.

You see, the whole business of the investment trust is trading in securities. You may meet a situation where there may be conflicts of interest between the officer buying the stock and the investment trust buying the stock. The officer may buy his first and get the stock at a cheaper price than the investment trust does.

We say in that situation that he ought to tell his board of directors that "I was trading in or buying securities which you have in our portfolio." He does not tell it to the Commission. He tells it to his own board of directors.

The fact of the matter is that this is not a novel provision. There are several investment trusts which—after we started our investigation—voluntarily adopted that provision, and went further than we did, and said that at the time the investment trust was trading in the securities no officer, manager, or employee should trade in such securities. So it is really a requirement of a practice which has been adopted by some investment companies already.

Mr. HEALY. Section 31 of the bill deals with accounts and records; and I think enough has been said to make it plain that the matter of accounts and accounting of these companies is an extremely important matter and lies close to the heart of a great many of the difficulties.

This section requires the keeping of accounts which are made subject to the Commission's inspection at any time. The purpose is to make these companies subject to the same type of examination as are national banks, although it is hoped that such extensive and regular examination will not be necessary in actual administration.

That, in general, is the import of sections (a), (b), and (c).

Paragraph (d) authorizes the Commission to prescribe uniform accounting rules; and this power extends not only to uniform methods of keeping accounts, but also to uniform methods of determining what entries should be made, and in what amount.

I would like to say that if this authority is given the Commission, it will be worked out exactly as the same authority was worked out under the Holding Company Act when we got up our uniform classification of accounts for holding companies and servicing companies. That was done in consultation with the industries and with the leaders of the accounting profession.

The lack of uniform standards and the lack of dependable standards in the accounting field has had very bad effects in many directions, and nowhere any worse than in the investment trust field.

Section (e) permits the enforcement of the uniform accounting rules by requiring by order that the company may make specific entries in specific books. Otherwise the only remedy would be the institution of punitive or injunctive proceedings for violation of the uniform accounting rules.

Section (f) is a technical qualification of the paragraphs that I have described. It permits the companies to maintain supplementary records, provided they do not impair the integrity of the accounts classified.

Section 32 is somewhat along the same line and deals with accountants and auditors. I will describe it very briefly and in very general terms.

Subdivision (a) requires that except in emergencies any independent public accountant retained by an investment company shall be selected by the company's stockholders.

I think that the benefits that may come from that are largely psychological, but it will help to bring home to the independent public accountant that he is not any longer retained merely to find out if somebody in the office force is stealing the petty cash or merely to inform the directors as to what has happened in their company, but that under the existing statutes and existing practice that independent public accountant is really acting for the security holders rather than for the management.

Senator HUGHES. The security holders have selected him?

Mr. HEALY. If this bill is passed the stockholders are to select the independent accountant.

Senator HUGHES. I thought I saw something in the bill about the voting securities.

Mr. HEALY. That is true. I did not realize you were making a distinction between voting securities and other securities.

Senator HUGHES. I wondered whether other securities had an interest.

Mr. HEALY. Under the terms of this bill all the holders of stock in the future will have voting rights, if the bill is passed.

There are of course some difficulties about getting the names and properties of other types of security holders, such as debenture holders. It did not seem wise to carry it that far.

Under subsection (b) the comptroller or other principal accounting officer of an investment company is to be selected by the company's voting security holders or by the board of directors, but not by the president.

Under subsection (c) the commission is authorized to prescribe the minimum scope of the procedure to be followed in audits and to require accountants and auditors to keep accounts, reports, and work sheets, and so one, and have them available for inspection.

We have had some talk with representatives of accounting societies and, as I understand it, the one objection they make relates to subsection (c) of section 32. They have some difficulty with the proposal that the commission be authorized to prescribe the scope of procedure to be followed in audits. I am very hopeful that we can work out some substitute language for that.

The difficulty arises, according to my point of view, at least, from the fact that no two accountants ever seem to agree on what an audit is. Every one that you meet has a different definition of audit.

When I picked up the certificate that was made by the auditors and attached to the McKesson & Robbins statement, and held it up alongside of a copy of the engagement or contract between the McKesson & Robbins Co. and the auditors, taking that in one hand and their certificate in the other, I was extremely surprised. I did not see anything in the certificate that gave a security holder fair warning as to what things the auditor was responsible for and what things he was not responsible for.

It may be that there is some other way of approaching this. I despair of ever coming to an agreement as to a definition of audit. It may be that if the Commission is authorized to set some minimum standards, or if the Commission is authorized to require an auditor to disclose in some general way what he does or does not do, that will meet the problem.

If the committee is agreeable, we will continue our discussions with the accounting societies with the hope that we can bring back something that will be acceptable to them and to the proponents of this bill.

Senator HUGHES (presiding). We will take a recess at this time until 2:30 this afternoon.

(Whereupon, at 12:45 p. m., a recess was taken until 2:30 p. m., of the same day.)

AFTER RECESS

The subcommittee resumed at 3 p. m.

Senator WAGNER (chairman of the subcommittee). The subcommittee will resume. I have no doubt other members of the subcommittee will be here in a few minutes.

Mr. HEALY. Mr. Chairman, might I make a brief statement at this time?

Senator WAGNER. Yes.

ADDITIONAL STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. HEALY. Before Mr. Schenker resumes his discussion of the bill I would like to offer for the record a memorandum showing the cost of the study and a description of the work completed by the investment-trust study of the Commission. This is the expense item that Senator Townsend asked for a few days ago. If he or anyone else desires a further break-down of it we will be glad to get it.

In that connection I would like to say that each year, when the Commission has been before committees of Congress dealing with appropriations, the status of the investment-trust study has been reported, and each year additional funds have been appropriated by Congress for carrying on the investigation.

Senator WAGNER (chairman of the subcommittee). That will be made a part of the record at this point.

(The memorandum referred to, dated April 10, 1940, is made a part of the record, as follows:)

[Memorandum]

APRIL 10, 1940.

To: Senate Committee on Banking and Currency.
From: Securities and Exchange Commission.
Re: Cost of study and description of work completed by the Investment Trust Study.