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.

I. Description of work completed by Study:

A. Public examinations:

250 companies subject of public examination.
33,000 pages of testimony taken in connection with public examinations.
4,800 exhibits introduced in connection with public examinations.
100 companies subject of field investigation.

B. Reports submitted to Congress:

Report	Date of transmittal	House Document No. and Congress	Approximate number of pages
Part one	June 10, 1938	707, 75th	160
Part two		70, 76th	940
Volume I (chs. I and II)	July 28, 1938		
Volume II (chs. III and IV)	Sept. 19, 1938		
Volume III (ch. V)	Oct. 31, 1938		
Volume IV (ch. VI)	Jan. 30, 1939		
Volume V (ch. VII)	Feb. 9, 1939		
Volume VI (ch. VIII)	Mar. 10, 1939		
Part three		279, 76th	3,000
Chapter I	Apr. 29, 1939		
Chapter II (first section)	do		
Chapter II (second section)	May 11, 1939		
Chapter II (third section)	June 14, 1939		
Chapter II (fourth section)	Aug. 7, 1939		
Chapter III	Oct. 10, 1939		
Chapter IV	Nov. 10, 1939		
Chapter V	Dec. 29, 1939		
Chapter VI (second and third sections)	Feb. 8, 1940		
Supplemental reports:			
Great Britain	June 26, 1939	380, 76th	75
Investment counsel	Aug. 17, 1939	477, 76th	70
Commingled funds	Aug. 30, 1939	476, 76th	50
Installment investment plans	Sept. 22, 1939	488, 76th	210
Fixed and semifixed investment trusts	Jan. 15, 1940	567, 76th	430
Face amount installment certificates [1]	Mar. 13, 1940	659, 76th	400

[1] Being printed at the U. S. Government Printing Office.

II. Cost of Study:

Fiscal year	Salaries	Number of employees	Travel	Witness fees	Reporting service	Total
1936	$68,066.23	58	$3,443.49			$71,509.72
1937	199,152.65	71	14,261.41	$3,238.67	$17,419.98	234,072.71
1938	112,234.60	35	10,829.50	2,147.60	2,346.99	127,558.69
1939	92,227.60	31	110.25	697.00	494.28	93,529.13
1940 (to Apr. 1, 1940)	54,612.41	[1] 26				54,612.41
Total	526,293.49		28,644.65	6,083.27	20,261.25	581,282.66

[1] Includes 8 lawyers, 3 accountants, and balance includes statistical and stenographic staff.

Mr. HEALY. Next, this morning when I was testifying I expressed the idea, possibly with some reservations, that the Federal Communications Commission had the same power, to approve or disapprove reorganizations in court which is given to the Interstate Commerce Commission under the Transportation Act, and given to the Securities and Exchange Commission under the Holding Company Act. I was mistaken. I understand they do not have any such power, although they are given power to appear and be heard in 77B or the Chandler Act cases as we should call them now, involving companies subject to their jurisdiction.

One other item: This bill does not have a provision covering the matter of notice and hearing in advance of orders to be issued by the Commission. That was not an oversight. It was omitted with the

deliberate intention of supplying it at a later date when the phraseology of it could be worked out in a satisfactory manner.

To be entirely frank about it, I think there is no harm in saying that one point as to which there was some doubt related to the question whether it was necessary to have notice and hearing in those instances where the decision was favorable to the applicant; or whether it should be merely confined to the cases where the question was open to doubt and there might be a difference of opinion as to what the result would be after hearing the parties.

Now, that provision will be compiled and submitted to the subcommittee.

Senator WAGNER. All right. Is that all, Judge Healy?

Mr. HEALY. Yes, Mr. Chairman.

Senator WAGNER (chairman of the subcommittee). You may proceed with your statement, Mr. Schenker.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUST STUDY, WASHINGTON, D. C.—Resumed

Mr. SCHENKER. Section 33 deals with settlement of civil actions in which investment companies are involved.

Senator WAGNER. What page of the bill are you on now?

Mr. SCHENKER. Page 74. During the course of our investigation we found that investment companies, for one reason or another, appeared to be particularly susceptible to representative stockholders, actions. Whether that is because of the nature of the activities of investment companies in that they may make investments and take losses and thereby may get disappointed stockholders, or whether it is attributable to the fact that there has been some prevalence of abuses in connection with that type of company, or whether misfeasance or nonfeasance is more prevalent in that institution, I would not attempt to say. I think the fact is that investment companies probably have been subjected to representative stockholder actions much more than industrial corporations, for instance.

Now, you have this problem: As Mr. Smith indicated, a management being in power and not wanting to have its activities aired in court, is in position to settle with the stockholder by buying his stock.

In a great many instances the investment company is really a nominal defendant because the officers and directors would not institute the action on behalf of the corporation. Under the rules of pleading and practice of many jurisdictions in such an instance the corporation has to be made a nominal defendant. You get the situation that in many cases the settlement is made, and instead of the officers and directors paying the settlement, or even the judgment, you may get the situation where the entire burden is borne by the investment company. The investment company may not have benefited from the misfeasance of the officers and directors; or even in the worst case, the officers or directors may have benefited from their wrongful conduct.

Senator WAGNER. Is that usually an action against the directors?

Mr. SCHENKER. It is usually a representative stockholders action. You may get a situation where one investment trust controls another and there is the claim that that investment company cleaned out the

controlling investment trust. The officers and directors of the investment trust are made party defendants.

Now, in such a situation the controlling investment company may be only a nominal defendant because the rules of practice require that it be made defendant where the officers and directors themselves refuse to institute the suit.

In that type of situation, although the persons who may have been guilty of the wrongful conduct, are the officers and directors—and in a more extreme case, they may have been the ones that benefited by their conduct—you may find that the damages, if any, are borne by the investment company.

Senator WAGNER. And there are some cases where, if prosecuted to the end, the corporations may not be found liable but the directors may.

Mr. SCHENKER. That is right.

Senator WAGNER. And in the settlement, of course, they absolve themselves in that way.

Mr. SCHENKER. Yes. That is the situation we are talking about. You may also get the situation, and I think there are cases like that, where there was a representative stockholder's action brought, and the investment company was not guilty of wrongful conduct but the officers and directors were. The case was settled, but instead of the officers and directors paying the settlement, they had the investment company settle it.

Fortunately in that case as I understand it the person who instituted the representative stockholders action was also a stockholder of the company which was being sued. Then he had to institute an action against the officers and directors for waste, for using the company's money to pay their own liability.

You also get cases, such as the extreme case of United Founders, where they pay a million dollars in settlement of a claim, and the only piece of paper that was served in that connection was a letter to the effect: Please take notice we have a claim against you. If you want to settle it we will be pleased to talk to you.

Well, the attorney had lunch with the officers of the company, and over the lunch table that case was settled for a million dollars without even the service of a summons or complaint.

Now, there the corporation itself is a fiction. If there was any wrongful conduct it must have been that of those persons who controlled the company. Yet the entire million dollars was paid by the investment company, and never at any time was there any disclosure in any report to stockholders, that a million dollars was paid in settlement of a claim which was asserted only in a written letter.

Now, what is the approach in this connection? We say in that type of case—a representative stockholder's action, or action predicated on wrongful conduct of officers and directors—that you cannot settle the case unless an action is instituted so that it is brought to the attention of a court.

Then we say—if it is in a Federal court—under the new Federal rules you cannot settle the representative stockholder's action unless the settlement is submitted for the approval of the court. And we say in that type of instance the Commission should be authorized merely to file an advisory opinion in connection with the settlement, so that the court may receive what assistance the Commission can give the court.

In that respect it is not unlike our approach in the Chandler Act cases, where we submit an advisory report, which the court may have and use.

I do not think I am disclosing any confidence when I say I happened to have lunch with the secretary of one of the judges who has been sitting in quite a few of these representative stockholder's actions, and he said he would feel this would be a great help. For instance, one may ask the court to approve a settlement of $1,250,000. The court does not know whether it is adequate or not, what the technical aspects of the transaction are which are involved, and so forth.

Senator WAGNER. I am only one member of the subcommittee, but I know that is very desirable.

Senator HERRING. That is what we have the courts for, to find these things out.

Senator WAGNER. I mean to have the aid of the Securities and Exchange Commission.

Senator HERRING. Certainly. A court ought to be given all the light possible.

Mr. SCHENKER. Now, in connection with the State courts—and of course the Federal jurisdiction does not apply there—we say if a State court asks us to submit a report and to give it what help we can, then the Commission is authorized to give the State court a report. That is, in the settlement of law suits.

Now, as to the remaining sections of the bill, I can run through a number of them quite hurriedly: Section 34, section 36, section 37, section 38, section 39, section 40, section 41, section 42, section 43, and section 44 are what we call boilerplate sections. They are really substantially the same provisions as are incorporated in our other securities and exchange acts. There may be some very minor changes, and if the subcommittee is interested I think we can submit a memorandum that will indicate what those slight changes are.

Senator HERRING. I am interested in section 28 dealing with face-amount certificate companies. We have them operating out in our State. You provide as I understand it for the deposit of certificates, or the assignment, or the placing of them, to cover face-amount certificates and their earnings.

Mr. SCHENKER. We provide that they have to maintain a reserve at a rate of 3½ percent which will enable them to meet their contract obligations when they mature.

Senator HERRING. And under our State law they must deposit them with the State. Now, of course, our State don't give up what it has, but you might stop them from further depositing them, and that in effect will stop them from doing business in our State.

Mr. SCHENKER. We were not unmindful of that situation. In almost all States or in a great many States, even if it is not required by statute, the securities commissioner may say: I will not let you sell your certificates here unless you have on deposit with me certain assets or mortgages or security that will insure payment of the certificates if anything happens.

Senator HERRING. That is what we have.

Mr. SCHENKER. That is an important subject and I will take it up in a minute. Unfortunately—and we have made a pretty detailed study of the company I have in mind, it is a big problem and is a big company.

Senator HERRING. Yes; and I take it you refer to the Minneapolis company.

Mr. SCHENKER. The Investors Syndicate, which we studied in detail. And we studied the Fidelity Investment Association of Wheeling, W. Va., in detail. We studied the United Securities Co. of Missouri in some detail. But particularly we studied the Investors Syndicate and the Fidelity Investment Association of Wheeling, W. Va., one having about 40 million dollars, and the other having many millions of dollars—

Senator HERRING (interposing). That is right, and it was a very important matter.

Mr. SCHENKER. Now, when we came to analyze the various agreements under which those securities were deposited with the various securities commissioners, although we had some of our best legal talent look at them, we could not really unequivocally say that such security, in the event the company went bankrupt, would be applicable to the certificate holder in the States which required security. There were certain Supreme Court cases which seemed to cast some doubt upon that fact. We asked them to submit a memorandum as to whether they would state unequivocally that all deposits made in a State would be applicable to the particular certificates sold in that State.

Senator HERRING. Well, we have possession of them and I would like to see them get them.

Mr. SCHENKER. Yes; of course you have possession of them. We used meticulous care to see that those States which have them can hold on to them. With respect to payments made on certificates already sold, you can keep those, too; but with respect to the future we provide differently.

Senator HERRING. I am interested in that.

Mr. SCHENKER. With respect to the future we think that this system should not be perpetuated, and for this reason: You may have an alert securities commissioner in your State and he may insist upon an ample deposit to cover your certificate holders. Then again, you can visualize a situation where there may be a securities commissioner who is not as alert. You might be surprised by the discrepancy that exists in the matter of deposit liability here and there. What we say as to the future is this: There should not be separate deposits, but if a company goes bankrupt then their certificate holders should share pari passu, and there should be no difference because a man lives on this side of the border of a State.

Senator HERRING. That may take place, but you cannot assume that the Federal authorities are any more competent than the State authorities. If you say that, then you may want to send everything down here to Washington.

Mr. SCHENKER. We are not unmindful of that, and we are not disparaging present deposits.

Senator HERRING. But your idea was that some insurance or securities commissioners are inefficient or incompetent.

Mr. SCHENKER. No; I did not say that.

Senator HERRING. You said that might occur.

Mr. SCHENKER. Oh, no.

Senator HERRING. That is a point we are somewhat touchy on.

Mr. SCHENKER. Oh, no; I did not mean that at all.

Mr. HEALY. I might explain that some States do not have those deposits at all. I think that when you are legislating for the United States you have to look to equal protection of all.

Senator HERRING. That is right.

Mr. HEALY. Without casting any reflection whatsoever on State commissioners, I think the fact that they are not all equally able——

Senator HERRING (interposing). That no doubt is true.

Mr. HEALY. There are inequalities among them; and some of them do not have the power under their own State laws that some other commissioners are given. Now, as Mr. Schenker points out, the existing status is not disturbed so far as the deposits are concerned. But I think a study will show that there are several States where the deposits are not large enough to cover the complete obligation that may later inure to the benefit of the citizens of those States.

Senator HERRING. Then the officers are derelict. We assume we are up to date.

Mr. HEALY. They may be going as far as their State law permits them to go. I am not blaming your State, Senator Herring.

Senator WAGNER. And you, Governor Herring, appointed them there and ought to know about them.

Senator HERRING. Yes; and I think I do.

Mr. SCHENKER. Does that answer that question?

Senator HERRING. Yes.

Senator WAGNER. You may now proceed, Mr. Schenker.

Mr. SCHENKER. I skipped one section of the bill, and that is section 35, which deals with unlawful representations and names. Subsection (a) is the provision which says that it shall be unlawful for a person to represent, just because he is registered under this act, that the company, or its securities, has been recommended or approved by the United States or any agency or officer thereof.

Then subsection (b) says it shall be unlawful for any person to make a similar representation about himself. In other words, subsection (a) really deals with securities, that one cannot make a misrepresentation with reference to securities. Subsection (b) says one cannot make such a misrepresentation with respect to a person; and then subsection (c) says subsections (a) and (b) do not prevent one from saying "I am registered under this act" if such statement is true in fact, provided he does not do that by saying or implying: By virtue of that registration the S. E. C. has passed upon the soundness of the security.

Subsection (d) is a provision which makes it unlawful to use any name that might be misleading, such as United States income fund, or New York income fund, or guaranteed dividends which will take care of your old age and your wife and your boy's college education. It is just the same thing as that there should not be some bank known as the Bank of the United States. That is what this subsection (d) is.

Senator HERRING. Section 36 of the bill, subsection (a) provides—

> The Commission shall have authority from time to time to make, issue, amend and rescind such rules and regulations and such orders as it finds necessary or appropriate to carry out the provisions of this title.

It seems to me that is a pretty wide discretion, particularly when you provide a penalty for violating rules which you may make or amend.

Mr. SCHENKER. I think Judge Healy would like to be heard on that.

Mr. HEALY. This is substantially the same provision that has been inserted in each one of our acts, and it was just carried over. In my opening statement, at the very beginning of these hearings, I made reference to this matter. I do not remember whether you were here then or not?

Senator HERRING. I am sorry but I was not present at the time.

Mr. HEALY. If you would like, I will be glad to read that. It is very short.

Senator HERRING. No; if it is in the record I will read it there.

Mr. HEALY. I do not feel that I could add much to what I said on that point.

Senator HERRING. You do not think it would be granting too great discretion to the Commission?

Mr. HEALY. I do not. I think that the argument, from my angle at least, is not in favor of obtaining power for the body of which I happen to be a member but is in favor of flexibility. You will find many situations where you can write a statutory standard without harming anybody. Then you find other situations where a strict statutory standard, with no rubber in it, will deal fairly with 90 percent of the cases and work an injustice in 10 percent. It seems to me it is very desirable that you make some provision for the unforeseeable and unpredictable instance that comes along that nobody can anticipate.

Senator HERRING. All right.

Mr. HEALY. However, as I set out in my statement, if the subcommittee feels that anything that is left to the Commission to administer is not accompanied by an adequate, a definite standard, we certainly will not make the slightest objection to having our administrative burden lightened.

I would like to say again what I said the other day: that I think any statute that permits the application of unlimited or unfettered discretion is unthinkable. I am a firm believer in the doctrine that ours is a Government of laws, and I have said it very emphatically before now, and in places where it did some good. My brother commissioners, I am sure, share this view. I can produce a document I filed with the fifth circuit if you would care to see it, in a certain case.

Now, I do not think you offend that principle when you say that the Commission shall make rules to accomplish the following; or when you set up a standard and give it to the Commission to administer. Of course if the subcommittee thinks otherwise, then they should write the bill the other way.

I would like to add this thought: I do not personally happen to believe that the administrative process can survive, or ought to survive, unless it can fit in with the American ideal of the supremacy of law. We do not have the power to make laws. Nobody has that power except the Congress. The Congress cannot delegate it to us or to anybody else. The *Schechter case* reminded us of that very forcibly. But you can write a law and then give us power to implement it or to fill in the blank spaces the Congress has to leave.

Senator HERRING. You think a saving qualification is appropriate in order to carry out the provisions of this title.

Mr. HEALY. It seems so to me. But if the subcommittee feels it should be further restricted, and it can be done without robbing its administration of its flexibility, I shall offer no argument against it.

Senator WAGNER. Right there let me ask you this question: If such a flexible provision were not in the act and let us suppose the Commission makes a definite rule to carry out the provisions of the act, on a definite standard, and you yourselves find that the rule you have adopted, because of a change in conditions or something or other, is a very unfair rule, where would you be? Well, there you are, with a fixed rule and with no authority here to rescind it. What would happen in a case like that?

Mr. HEALY. Well, if we did not have authority to rescind it I think we and the people affected by the rule would be in a very unpleasant predicament. But if we should adopt a rule of that sort I should think it would be our duty to rescind it immediately.

Senator HERRING. Perhaps there might be quite a bit more care used in adopting a rule in the first place in those circumstances.

Mr. HEALY. Let me say this: that if we were to adopt a rule, and if a person is affected by that rule and there is an actual, judiciable controversy between him and the Commission, he could get a court review, could get a court decision on the subject of the validity of our rule.

Further than that, while I of course will not vote for any rule in the Commission that I do not think is authorized by the statute, yet if a litigant comes before the Commission and shows me we have adopted a rule that is outside of our powers, or even a rule that is inside our powers but is unwise, I shall not hesitate to vote to abrogate it. And my pride will not be hurt the least bit in doing it.

Senator WAGNER. The point I tried to make, Judge Healy, although I may not have made it clear, was that the mere fact of the power being given to you to make rules and regulations implies the power to rescind or modify them. I was wondering why this provision is necessary at all.

Mr. HEALY. Well, the question is——.

Senator WAGNER (continuing). You are a lawyer and so is Mr. Schenker, and all your distinguished attorneys ought to be able to enlighten us on that point.

Senator HERRING. I am the only one here who has no curse on him. [Laughter.]

Mr. HEALY. Well, of course we do not have the power to make rules unless the Congress gives it to us.

Senator WAGNER. I mean if given the power to make these rules and regulations, and if there is nothing further said in this bill, does it not imply that you have the power to modify or to amend those rules at any time?

Mr. HEALY. Yes, sir; I should think so.

Senator WAGNER. So that even if this provision were not in here I should think you would have that power.

Mr. HEALY. The implied power?

Senator WAGNER. Yes.

Mr. SCHENKER. But this provision deals with another aspect of the subject because it says:

> The Commission shall have authority from time to time to make, issue, amend, and rescind—

Now, that means to amend, rescind, or abrogate what?

> such rules and regulations and such orders as it finds necessary or appropriate to carry out the provisions of this title, including rules and regulations defining accounting, technical, and trade terms used in this title—