doing exactly the same thing to the senior securities of any American business.

And now let me come to two other arguments that have been advanced. They say that the securities of the investment company should only be common stock like banks and insurance companies. They say they have no senior securities outstanding. This is, in my opinion, technically true, but I think it only tells half the story; it is only a half truth.

Look at an investment company balance sheet and you will see on the liability side the bonds outstanding, the bank loans if there are any, and the preferred stock and the common stock. They are shown as liabilities of the investment company. The bank loans have a fixed maturity; the bonds have a fixed maturity; but the preferred stock has no maturity.

Look at the balance sheet of a bank, and what do you see on the liability side? You see demand deposits in a ratio to junior capital which is infinitely larger than in any investment company. I say that that is just as much senior money as the bonds and preferred stocks of an investment company, but there is one radical difference. The senior money contributed by the depositors must be repaid, and must be repaid on demand.

Take an insurance company and you have an analogous situation. You have the present and potential claims of policyholders which must be met when they fall due, and nobody knows when they will fall due.

To compare investment companies with banks and insurance companies to my mind simply doesn't make sense. They are three different kinds of animals. They say that an investment company ought to be a mutual enterprise. Now this word "mutual" appears in their report but I must confess that I don't understand exactly what it means. The report reiterates the belief that there is a conflict of interest between the different types of securities, imposing conflicting duties on management because the risks, losses, and gains are not equally distributed In what respect is this different from any senior security in any enterprise? To be logical you would have to extend this principle to every form of American business. What is so essentially vicious about a group of investors pooling their money for the purpose of diversifying risks with one group deciding to participate in income and assets on one basis and another group on another? Each interest profits if the investment enterprise is successful. Each interest suffers if it is unsuccessful.

You don't try to solve this possible conflict in other businesses by eliminating all but one group of security holders. It s left to responsible management to work out.

I have been a director of companies with more than one class of securities over a considerable number of years, good times and bad, though in retrospect I must say that they seem to be mostly bad, and I must confess that I have not found any irreconcilable conflict of interest in the existence of more than one class of security.

You do the very best you can even though the results may be disappointing to you. You consider the rights of both classes of security holders just as management of any business does. You try to handle your affairs in such a way that the best interest of both classes will be served without discriminating in favor of one and against the other. I think, gentlemen, that if you try to legislate

possible so-called conflicts of interest out of life you are entering upon an impossible and futile task.

I would like to end this part of my discussion regarding mutuality of investment companies by quoting from one section of the S. E. C. report. The report reads:

> Thus the function of supplying a single investment security which effectively combines the dual qualities of safety and possibility of substantial profit is not served by the multiple securities investment companies which divorce these two objectives.

I frankly don't know what this means, and it is not, therefore, very helpful to me in understanding their argument about mutuality. It sounds uncommonly like the old story of the investor whose modest requirements included 6 percent return, absolute safety of principal and about a 50-percent profit.

Certainly the S. E. C. cannot pretend to argue that their proposed common stock set-up will guard against losses. Bad management or bad times will always cause losses. But to the S. E. C. there is apparently something sacred in sharing these losses equally and not in proportions agreed upon in advance by various types of security holders.

And now I come to the concluding argument used by Mr. Schenker in justifying the future abolition of senior securities. I would like to quote the testimony:

> Now if I may be a little slangy about it, we don't think it is worth the fuss to draw an elaborate provision which probably would be, page by page, to provide for the situation where a company may want at some subsequent date to issue a little preferred stock.

This is a strange argument, in my opinion, in view of the 104 pages of the present bill and the complexity of some of its provisions.

I have attempted to deal with the testimony on capital structures as presented to this committee.

Now I would like to take the other side.

The S. E. C. admits that the diversification of risks achieved through an investment company is a very desirable element of safety for the small investor.

Now, you and I know many investors who are looking for that diversification of risk but who, because of their own needs or wishes, don't want or can't buy common stocks. They need or want the stability and regularity of income and they need the protection of principal embodied in a senior security. The senior securities of investment companies can and have supplied this need. Of course there have been fatalities and of course there have been senior securities of investment companies which haven't lived up to the expectations of the purchasers; but no one tries to legislate on the basis of what Mr. Bunker has rightly pointed out to be samples of the worst. One doesn't legislate all savings banks out of existence because some of them have failed with losses to their depositors.

If you really feel that the investment company has a proper place in the American system, leave a place in the future for those investors, and there are many of them, who do not want the risk of fluctuating and variable income of common stock. Let him diversify his risk in the form he wants it. Make sure that if he is sold a senior security he knows what he is getting. If you think wise, require certain protective provisions in future issues of senior securities. That, to my

mind, is the proper approach. It seems to me poor policy, however, to go to the length proposed in this bill and tell the investor what he can and should buy, override his own personal needs or desires, and legislate any individual choice out of future existence.

I would like to end my comment on this provision of the bill by asking how one would explain this drastic departure in security legislation to an investor who was a satisfied holder of a good senior security of an investment company. I imagine the conversation would go something like this on his part:

I bought the bonds of the X Investment Co. and the preferred stock of the Y Investment Co. I certainly wasn't misled into thinking that they were high-grade securities, but I must say that they have been as satisfactory a holding for me over the last 10 years as my high-grade security. In my high-grade bonds I have been continually having my income reduced and I am certain that when the money rates change I am going to see a pretty substantial decline in capital value.

Only the other day one of the companies offered to buy back some of its preferred stock and called for tenders. Their stockholders must feel pretty much the same way I do. I noticed they only got about half the stock they wanted.

Of course I know that not all of the holders of senior securities of investment companies have had an equally satisfactory experience. I don't see, though, what that has to do with it. Why destroy something that has turned out bo be good for me and some others just because it has been unsatisfactory for somebody else?

I know that certain investment companies and their managements have done things which were not right, but I don't happen to have held the securities of those companies. It doesn't seem sensible to me to try to cure cases of dishonesty by abolishing senior securities in the future. That somehow sounds funny. It sounds as though the people who were proposing it hadn't been able to figure out a proper way to sensibly regulate the business.

They tell me that some senior securities of investment companies didn't do well. I'm not surprised, seeing what happened to most securities. But mine did. I don't see, though, again, what that has to do with the question.

If you once begin to legislate senior securities out of existence, where do you stop? I don't see any difference between saying that an investment company can't have a senior security and saying that a steel company can't have a senior security. They both have their ups and downs. They both do well in good times and do badly in poor times. That doesn't sound to me like a sensible argument for abolishing senior securities of investment companies. If there's anything to the argument, it's an argument for wiping out all senior securities.

I am not interested in buying common stocks. I'll buy them indirectly through an investment company because I get a spread of my risks. But I need a constant and steady income. I can't afford to have my income fluctuate the way a common-stock investment will inevitably do. I am retired and I want to count on a certain amount of income.

Now, it seems to me that if they're hell bent on going that far in legislation, instead of saying that you can't have any senior securities in an investment company the best way would be to say that investment-company senior securities in the future can only be issued under certain restrictions. The restrictions around the securities I bought were apparently satisfactory because my experience has been a good one. Why don't they just adopt those and make all companies do that?

I think, gentlemen, that if you tried to explain the abolition of senior securities to a gentleman who has had that experience, you would have a rather difficult task.

I should now like to turn to another important phase of this discussion. In testifying regarding this section, it was repeatedly stated that this ban on senior securities applied only to the future—that no existing situations would be disturbed. I cannot agree with this statement, and I should like to explain the basis for my disagreement. I shall therefore run rapidly over those parts of the present bill which touch existing capital structure, in many cases vitally.

Section 5 classifies investment companies. It starts out by defining a "diversified investment company." A mere example makes clear what I mean. The classification of a diversified investment company would exclude a company which had then a small amount of senior securities outstanding and regardless of its investment policy it could not qualify as a diversified investment company. I think you will agree with me that being a "diversified" company may have something very important to do with future tax treatment.

Not only are senior securities to be legislated out of future existence but their existence in the capital structure of any company may penalize that company in future tax treatment.

If one turns to section 14 one finds that the bill provides another immediate handicap on investment companies having senior securities.

If a company is a diversified investment company its size is restricted to $150,000,000. I can have exactly the same kind of company as the so-called diversified company under this definition; I can have exactly the same portfolio, exactly the same kind of management, exactly the same kind of successful running of it, but if I have a small amount of senior securities out, my size is not $150,000,000, but $75,000,000.

Section 18 of the bill is that section which forbids the future issuance of senior securities. That part of the section is a clear and understandable statement of future policy, but it contains two subsections which have important present effects.

Section 18 (c) says that it shall be unlawful for any investment company in the future to issue any warrant except a short time right to subscribe. This sounds simple and is a logical accompaniment of their proposed ban on all securities other than common stock. But some investment companies have outstanding warrants which give the holders the right to subscribe in the future to common stock at set prices. And that is a regular feature of any warrant.

The future value of these warrants, therefore, depends to a great extent on the fact that a holder has the right to purchase the stock of an investment company at a fixed price regardless of what may be its liquidating value or market price when he chooses to exercise that right. If he has the right to subscribe for stock at $10 a share and the liquidating value of stock has increased to $20 a share, this measures the arithmetic worth of the warrant to him. It may be a very valuable right for which he has paid money. It may be a right for which he has paid money which he hopes will be of future value to him.

What becomes of these rights, however, when one turns to section 23 (a) of the bill and reads that no registered closed-end management company shall issue or sell any security in contravention of such rules and regulations or orders as the Commission may prescribe to prevent or limit such issuance or sale at a price below the current asset value. Under the act as written the value of the outstanding warrants of an investment company can be worth exactly what the S. E. C. makes up its mind to make them worth. They can be worth what the man honestly thought they were when he bought them or they can be valueless.

If you read on to paragraph (d) of that section of the bill which limits future securities of investment companies to the single classification of common stock, you read that extraordinary provision which

I have already referred to in these hearings giving the S. E. C. the right to redistribute the voting rights and privileges of outstanding securities. I think that you will agree that these two paragraphs alone are a considerable departure from the stated policy of the sponsors of this bill to leave existing situations alone.

Section 19 of the proposed act again touches the subject of senior securities by setting out future restrictions on the declaration of dividends of investment companies. I have already dealt with this section in my testimony of the other day and will not repeat my comments except to point out that here is another place where the bill definitely touches outstanding securities of an investment company and touches them in a most vital and very important way.

Section 21 again comes in and touches present outstanding senior securities. It covers the question of loans by an investment company and provides that it shall be unlawful in the future for any registered management company to borrow money from a bank or other persons except for temporary purposes, and in an amount not exceeding 5 percent of the value of the company's total assets. This sounds as though it banned future bank loans, but gave the companies the right to renew them up to July 1, 1945, which is one of the provisions of that section. This section, however, goes a great deal further. It means that any bond or debenture of an investment company which may mature after July 1, 1945, can never be extended or renewed. However well covered by assets or earnings this obligation of an investment company may be, the company has no option in the future other than to repay it at maturity. The holder is deprived, however satisfactory the investment may be, of accepting either an exchange offering or a new security of similar type.

Section 25 deals with reorganizations and recapitalizations. As I stated in my testimony of the other day, it gives the S. E. C. more authority over the reorganization of solvent companies than they presently have over the reorganization of insolvent companies under the Chandler Act. You may well ask why this has anything to do with senior securities. Let me point out to you that a company having senior securities and desiring to simplify its structure or merge with another company can only do so with the permission of the S. E. C. Under the law as proposed they could not issue anything but common stock, except with the permission of the Commission. But the S. E. C. under the section I am discussing could exempt the company from that provision if it so wishes. But they have the decision in their hands. Even if the stockholders are unanimous in their wish to go forward with a plan of reorganization or merger, they are powerless to effectuate their mutual desires and wishes unless and until they receive the blessing of the Commission.

I have dealt with these various sections of the bill which affect senior securities to make clear that this bill includes not merely a ban on the issuance of senior securities in the future. It touches existing situations, and touches them with a heavy hand. Existing rights can, if the Commission so wishes, be scuttled, and existing privileges of senior and junior securities can be set aside by the Commission if it so desires.

It is true that the present bill does not contain a clear-cut death sentence on outstanding senior securities. It does contain, however, real possibilities of slow strangulation.

Now, Mr. Chairman, we have come to the end of our presentation. Through your kindness we have tried to present an over-all picture of the bill. We have dealt only with the more important questions, because the minutia of the bill is too difficult to deal with at length. We have tried to be helpful; we have tried to give you our views of the bill as we, being men with some practical experience in running these companies, see it. I hope that we have been helpful. I hope we have succeeded in impressing you with the soundness of our views. But whether we have succeeded or failed, we are deeply obliged to you, Mr. Chairman, and to the other members of the committee, for your courtesy and your consideration.

Senator WAGNER. Thank you very much. Your presentation of course has been helpful.

We will begin tomorrow at 10:30 a. m. with the open-end companies.

(Whereupon, at 4:25 p. m., the subcommittee adjourned until tomorrow, Tuesday, April 16, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

TUESDAY, APRIL 16, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Downey, Townsend, and Taft.

Present also: Senators Adams and Danaher.

Senator Wagner. The subcommittee will come to order. Mr. Traylor?

Mr. Traylor. My name is Mahlon E. Traylor.

Senator Wagner. You represent the Massachusetts Distributors, or at least you are an officer of it, are you?

Mr. Traylor. Yes, sir.

Senator Wagner. We will be glad to hear you. You may proceed.

STATEMENT OF MAHLON E. TRAYLOR, PRESIDENT, MASSACHUSETTS DISTRIBUTORS, INC., OF BOSTON, BOSTON, MASS.

Mr. Traylor. My name is Mahlon E. Traylor. I have been continuously affiliated with the investment trust business for the past 17 years. I am president of Massachusetts Distributors, Inc., of Boston, an organization engaged in the wholesale distribution of the shares of three open-end trusts, namely, Massachusetts Investors Trust, Boston Fund, Inc., and Supervised Shares, Inc. In the past 5 years, the company of which I am head has executed purchase and sales orders for more than $150,000,000 of the shares of these open-end management trusts.

The section of the industry for which I speak comprises the companies known as open-end management trusts, with redeemable shares. The purpose of my statement is to make clear to the members of this committee the present position and past record of these open-end management trusts, and to state in general terms the attitude of a representative group of such companies toward the Wagner-Lea bill.

Most of the testimony you have heard from S. E. C. witnesses in the past 2 weeks dealt with such lurid examples of mismanagement and dishonesty that it might easily have created the impression that such actions were typical of the entire investment trust business. In this connection, we want you to know, Mr. Chairman, that we have appreciated greatly the pains that you and the members of your

committee have taken to remind such witnesses that there were, after all, a great many honest and capably conducted investment companies.

What the open-end trusts are: Diversified investment companies in the United States may be divided roughly into two general types:

1. So-called closed trusts, which have fixed capitalizations and do not sell new shares. Many companies of this type have senior securities; that is, bonds or preferred stock, as well as common stock, outstanding.

2. So-called open-end trusts, whose holders are entitled to redeem their shares at any time at approximate liquidating value. These trusts customarily sell new shares on a continuing basis to replace old shares redeemed and to increase the amount of their funds. Virtually all open-end trusts limit capitalization to common stock only.

The following comparison shows the relative importance of diversified management open-end trusts and closed diversified management trusts, as of December 31, 1939. The companies included have been taken from classifications as shown in Moody's Bank and Insurance Manual. The figures given for closed trusts include only those that maintain diversified portfolios. Holding companies have been excluded:

	Combined assets
Closed trusts, with senior capital	$517, 000, 000
Closed trusts, without senior capital	180, 000, 000
Open-end trusts	554, 000. 000

A list of companies included in the above totals will be furnished upon request.

Open-end trusts are true investment vehicles, designed to give the small investor a well diversified investment with supervision by qualified management.

Senator TOWNSEND. Do you mean that those are the trusts that you are representing?

Mr. TRAYLOR. The figures $554,000,000; yes, sir.

Senator TOWNSEND. Would you care to put in the record a list of them?

Mr. TRAYLOR. I will furnish a list later.

Senator TOWNSEND. All right.

Mr. TRAYLOR. For this reason, they are frequently referred to by the Treasury Department as mutual funds, and most of them receive special tax exemption under the revenue act because they qualify as such under the tax laws.

Open-end trusts that qualify under the revenue act do not invest more than 5 percent of their funds in the securities of any one company, nor can any such fund hold more than 10 percent of the outstanding stock of any one company.

Trusts of this type have enjoyed their greatest growth since the passage of the Securities Act of 1933, and most of their outstanding capitalization has been issued in accordance with the full disclosures required by that act. Although some years ago they comprised only a small segment of the investment trust business, they are now a highly important factor in it.

How the open-end trusts operate: Open-end trusts, when they are incorporated companies, operate under the supervision of a board of directors. When such trusts are voluntary associations, instead of corporations, they are managed by one or more trustees.

Funds are invested in a diversified list of securities—in many cases principally common stocks—which are kept under constant supervision by the management. Securities may be bought and sold whenever the management deems advisable. The objective is not speculative profits, but satisfactory long-term investment results. Securities owned by the trusts are held by an independent custodian—usually a bank or trust company. There are usually restrictions against borrowing, trading on margin, and short selling.

The managements of open-end trusts usually continue without change, and shareholders purchase their participations because of their knowledge of, and confidence in, a particular management group. Open-end companies are unlike any other type of investment company, principally because of the highly important distinguishing feature that their shareholders can, by contract right, withdraw their proportionate interest at will simply by surrendering their shares to the company for redemption at liquidating value. Thus, in the event of dissatisfaction with the management or for any other reason, shareholders always have the right to withdraw—just as the maker of a voluntary trust can reserve the right to withdraw his trust from a bank or trust company if he is not satisfied with the way his funds are being handled. This right to withdraw may also be likened to the right which wealthy investors reserve in placing their funds under the discretionary management of an investment counselor. The threat of withdrawals in case of bad management is the best incentive there can be to good management.

The managements of open-end trusts are compensated on a fee basis. The usual fee is one-half of 1 percent annually of the asset value of the fund.

Senator TAFT. What is the legal status of these funds? Does it mean that any and every stockholder can withdraw?

Mr. TRAYLOR. That is right.

Senator TAFT. Is he in fact a stockholder?

Mr. TRAYLOR. Yes; he is a stockholder.

Senator TAFT. And it is a corporation.

Mr. TRAYLOR. I should add, except in the case of a trust where he is a shareholder of a beneficial interest.

Senator TAFT. Can you do that with a corporation?

Mr. TRAYLOR. They own the trust, and under the laws of Massachusetts they all have equal rights the same as in a corporation. They can liquidate at the liquidating value at any time they care to, sometimes within 2, 5, or 7 days, but in most cases the policy is to give them their money within 24 hours after they deposit their stock.

Senator TAFT. But this withdrawal feature would not apply to every case, would it?

Mr. TRAYLOR. They are set up with that contract right. That has been one of the principal things in the open-end industry, starting in 1924. The shareholder always has the right to get his money out at liquidating value, whatever that may be, at any time.

Senator HERRING. Does he have a vote in the conduct of the business?

Mr. TRAYLOR. Yes, unless it is a voting trust. In the case of Massachusetts trusts he does not have the voting right because those trusts are managed by trustees.