Senator HUGHES. I think we have all felt more or less that we have taken more time than we should have.

Senator DOWNEY. You have a prepared statement, Mr. Eberstadt?

Mr. EBERSTADT. Yes.

Senator DOWNEY. I take it he could not very well depart from that prepared statement and properly present what he has to say.

Senator HUGHES. Well, I do not know about that. Everybody is doubtless familiar with what is in the statement, and perhaps he could leave his statement here for our record, taking up at this time such portions of it as he wishes to emphasize. The portion that he does not read can be printed in the record of our hearings.

Mr. EBERSTADT. With your permission I will start out with my statement, and at your suggestion will be glad to leave out anything that you think is not relevant to the inquiry, although I hope I have not anything of the kind in my statement. You will realize I am sure that this is something in which we are deeply interested. However, I may put in something that you think is not necessary, and if so please stop me.

Senator HUGHES. We will not stop you. You may go as far as you think necessary.

Mr. EBERSTADT. I have taken the warning, and certainly take it in good spirit, and will have it in mind in presenting my statement, Mr. Chairman.

Senator DOWNEY. Mr. Chairman, before the witness proceeds with his statement might I have a word to say?

Senator HUGHES (presiding). Certainly, Senator Downey.

Senator DOWNEY. I have a letter from Henry S. McKee, president, Pacific Southern Investors, Inc., and American Capital Corporation, of Los Angeles. The letter is quite brief and I would like to read it to the presiding officer and Governor Herring:

> My associates and I here will immensely appreciate it if you will read the attached statement and see that it goes before your committee in the investment trust matter and becomes part of the record of the hearing.
>
> It has two purposes:
>
> 1. To prevent a shocking injustice.
> 2. To protect the committee from acting upon misinformation.
>
> If you can do this it will save us from traveling from California to Washington and back to present it.
>
> We would also like to state, for the record, in lieu of personal appearance, that we have read the testimony of Mr. Bunker and, out of our experience of 13 years in this business, concur in it fully.

From what I know in a general way Mr. McKee is a highly reputable and able businessman, and his organizations are very high class. Unfortunately it appears that in Mr. Schenker's testimony—and I have already consulted with him about it, Mr. Chairman—there is a marked ambiguity. Mr. Schenker was speaking generally of certain other investment corporations. His remarks were not meant to apply to this particular corporation, but the way the record reads one would clearly deduce that it does.

I will not read this statement, Mr. Chairman, and it may be placed in the record, but it will clarify the situation. Furthermore, Mr. Schenker has himself suggested that he would like to make some statement about the matter at this time.

Senator HUGHES (presiding). Without objection the statement will be made a part of the record at this point.

(The statement submitted by Senator Downey is as follows:)

STATEMENT REGARDING A CHART HEADED "AMERICAN CAPITAL GROUP;" AND REGARDING THE TESTIMONY THEREON OF MR. SCHENKER ON APRIL 9TH. BY HENRY S. MCKEE, PRESIDENT, AMERICAN CAPITAL CORPORATION, PRESIDENT, PACIFIC SOUTHERN INVESTORS, INC.

In connection with the chart headed "American Capital Corporation," there appeared a statement by Mr. Schenker which is untrue and misleading if applied to these companies.

Regarding this chart, Senator Wagner asked:

"Can you tell us the reasons for all of these organizations? You investigated this matter, did you not?" Mr. Schenker replied:

"Oh, certainly. The reason is that by doing this you can solidify your control of the particular situation. They would control the one company. And it has not been unusual, as we have shown, that they buy control, in the first instance, over that borrowed money by which they reimburse themselves for the sale of dubious securities, and they buy management stock. There is one case where $30,000,000 of the public's money was raised and the management stock was sold, for 50 cents a share, for $200,000.

"In that particular instance the management sold its management stock for a very substantial amount, and control was turned over to somebody else. Then they get control over part of the management stock, and take the investment trust funds and buy the common stocks of other companies which have money of the senior security holders, and in that way they can build up this very substantial pool."

It would appear from careful reading that Mr. Schenker was generalizing rather than referring specifically to our companies and yet the nature of the question, with the chart before the committee, was such that Mr. Schenker's answers contain an insinuation with rerpect to these companies that is wholly misleading.

The truth about the matter is as follows:

1. In 1927 in Los Angeles five men, among the best known and most highly respected citizens in the community, organized Pacific Investing Corporation.

They acted upon every sound principle of law, correct business ethics, fairness, justice, and honor. They were the directors. The company was successful far beyond their expectations.

2. A year later, in response to a strong demand upon them from substantial and intelligent investors, the same men, with two additions, organized American Capital Corporation.

This also was gratifyingly successful.

These two corporations had practically the same directors and were almost exactly alike. It was therefore later decided to merge them into one, for simplicity and economy.

The first step was that American Capital offered to issue its common stock in exchange for the common stock of Pacific Investing Corporation, and thus acquired most of it. The insinuation that the directors, who were virtually the same in both companies, were scheming for one to control the other is thus seen to be pure nonsense. The completion of the intended merger was prevented by the events of the ensuing long depression.

3. In 1932 Pacific Investing Corporation acquired the assets of Southern Bond & Share Corporation, of Birmingham, Ala., by a merger after long and fair negotiations, with almost unanimous approval of all stockholders of both companies. The resulting merged company was called Pacific Southern Investors, Inc.

Its board of directors became practically a merger of the personnel of the boards of the two merged companies. A large part of its common stock of course still continued to be owned by American Capital Corporation.

4. A couple of years later Pacific Southern Investors, Inc., bought about half of the stock of The Investment Company of America an investment company located in Detroit, of sound quality and managed by men of the highest ability and character. This was done in the belief that it would be a sound and profitable investment, which it has since proved to be.

5. But it happened that prior to the making of this investment the Investment Company of America (none of the officers or trustees of which had been a director of Pacific Investment Corporation and only one of whom had been a director of Southern Bond & Share Corporation) had bought, purely as a good investment (which it proved to be), a rather small amount of the stock of American Capital Corporation.

6. By that innocent and wholly proper and desirable course of events, it thus came about that American Capital could control Pacific Southern; Pacific Southern could control Investment Company of America (had they wished to do so, which they did not) and Investment Company of America owned some stock (by no means control) of American Capital Corporation.

7. But we realized that such intercorporate relationships, even though properly arrived at as in this instance, are always open to misunderstanding and criticism; so we at once (in 1934) began a series of steps to separate these companies from one another.

8. As the first of these steps, American Capital Corporation promptly disposed of all of the securities of Pacific Southern Investors, Inc., which it owned. Instead of selling this potential control in the nefarious manner which the Securities and Exchange Commission seems to consider customary in this industry, the American Capital Corporation gave its own stockholders the prior right to buy from it the Pacific Southern securities, which the stockholders did.

9. The next step was for Pacific Southern Investors, Inc., to dispose of its investment in the Investment Company of America, and it has been in the course of doing so steadily for many months. Again, it is not selling this potentially controlling block of shares to someone in the way the Securities and Exchange Commission insinuates. It is selling them gradually on the market, in the usual way, to many investors at a fair and just price under Securities and Exchange Commission registration.

Conclusion: The companies here mentioned have, from the beginning, been conducted by honorable men with the most scrupulous regard for law, business propriety, high ethical standards, and the fullest rights of stockholders. Except for the fact that they did not foresee the full ruinous severity of the financial convulsion of 1929 to 1932, their record of performance has been highly creditable and excellent, of which abundant public proofs exist.

We resent deeply the injuries done us by reason of the false implications to be drawn from Mr. Schenker's testimony as reported in the transcript of the hearing and respectfully urge that the foregoing statement be presented to the members of your committee and of the Congress as fully and forcibly as is possible.

Senator HUGHES (presiding). We will be glad to hear Mr. Schenker.

Mr. SCHENKER. Mr. Chairman, I am inclined to agree with Mr. McKee that the present state of the record may be susceptible of the inference that my general discussion with respect to the practice of acquiring control of investment trusts, and the particular illustration I gave, might refer to his company. That is not the fact.

Our relations with the American Capital Corporation have been of the highest cooperative standing, as they have given us all the information we requested. The fact of the matter is that the particular passage he refers to was in response to a general question by Senator Wagner: Why do they have one investment trust buy control of another, as exemplified in the various other cases which I discussed in some detail before I mentioned American Capital Corporation?

I think Mr. McKee's feeling in the matter is entirely justified. I think the record ought to be unequivocal that the particular portion of the discussion he quotes was not applicable to any of his companies.

Senator HUGHES (presiding). I thank you, Mr. Schenker. We will now hear Mr. Eberstadt.

STATEMENT OF FERDINAND EBERSTADT, PRESIDENT OF F. EBERSTADT & CO. INVESTMENT BANKERS, 39 BROADWAY, NEW YORK CITY

Mr. EBERSTADT. My name is Ferdinand Eberstadt. I am the president of F. Eberstadt & Co., investment bankers, specializing in the underwriting and distribution of securities of medium-size companies. I am also president of Chemical Fund, which is an open-end

investment company, whose portfolio is confined to securities of seasoned companies in the chemical and chemical-process fields.

While the name Chemical Fund appears to be limited to a special field, under the definitions of the bill it would probably and could properly be treated as an open-end diversified investment company, in view of the wide variety of products and processes embraced within the terms chemical and chemical process, which are said to include over 20 percent of the manufacturing business of this country.

It is a newcomer and one of the youngest companies in the investment trust field, having been organized something under 2 years ago with an original investment of $100,000 made privately by ourselves and some friends. Its net assets currently are in excess of $8,500,000. It has over 780,000 shares outstanding, all common stock, held by approximately 4,500 stockholders throughout the country, whose holdings average about 170 shares, or slightly under $2,000, each. Originally offered to the public at $10.81, the shares are now selling at a substantial advance over this figure and recently reached their highest price.

So far as I know Chemical Fund has never been subjected to criticism or complaint from any of its shareholders, the S. E. C., any "Blue sky" law commission, or any security dealer.

Our attitude toward this bill is expressed in an excerpt from our current annual report to stockholders, as follows:

> While the present draft of the bill in certain respects is deemed objectionable and it will be the policy of your company to oppose the passage of the measure in its present form, on the other hand, your company favors and will cooperate toward the passage of a bill with reasonable provisions.

We would welcome legislation which would not only drive out crooks and embezzlers from the business, but which would generally establish a high standard of business ethics and conduct.

My opposition to the bill is not solely because of any particular effects which it might have on Chemical Fund. So far as I can make out, although I don't feel sure because of the length, complexity, and vagueness of the bill, Chemical Fund would be affected by the definite and mandatory provisions of the bill only in two respects. These, however, are matters of considerable importance.

In the first place, we would lose one, and possibly two, of our valuable outside independent directors. In the second place, we would have to make an inconvenient, wholly artificial, and perhaps expensive, rearrangement with respect to mechanics of management.

When we decided to organize an investment company in the chemical field, we made a study of over 50 different investment trusts of various forms and types, and came to the conclusion that the open-end investment company with redeemable shares, which, in order to qualify as a mutual company must restrict its investments to not more than 5 percent of its assets in any one company and own not more than 10 percent of any one company, was the form best adapted for the purpose, as the provisions and restrictions of such a trust seemed to us to afford to its stockholders the maximum of protection against its use as a vehicle for purposes or objectives in conflict with their best interests.

In connection with the preparation of our set-up, I would like again to express appreciation to Mr. Schenker and his associates for the generous manner in which they put their time and advice at our disposal.

But in spite of the fact that Chemical Fund seems to be affected only to the limited extent that I have indicated above by the clear and definite provisions of the bill, the gist of my position is that I recommend against any bill at this time and against the bill in its present form at any time.

My objection to any bill at this time is based upon my feeling that investment trusts constitute such an enormous reservoir of potentially productive capital, so closely related to the capital market generally, that they should not be treated separately and apart from the subject of capital investment generally.

Paragraph 4 of section 1 of the bill itself recognizes this fact in stating that investment companies

> are media for the investment * * * of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets.

There has probably never been a time in the history of this or any other country when there has been so much capital available for investment, nor has there in our history, in my opinion, ever been a time of greater need and opportunity for investment. But one of the important obstacles in the way of bringing these two elements together is the fact that the two fundamental Federal securities laws, namely, the acts of 1933 and 1934, have the same serious defects of detail, not of principle, that are so evident in the bill which is before your committee for consideration.

We can only maintain and improve our standard of living through increasing wages and salaries, reducing manufacturing costs, and improving the quality and lowering the price of the product to the consumer. There is no real inconsistency between rising wages and decreasing costs and prices. This can and must be achieved by more efficient installations resulting from research and acquired through investment of capital. In the same way and from like sources new industry must be started and nurtured. By putting at the disposal of labor and management more up-to-date and more efficient methods and installations, each can earn a larger return and together produce a better product at a lower cost.

Either the free flow of capital, which is present in abundance, must be restored or this deficiency will have to be supplied by Government, or the standard of living cannot be maintained.

We are not one of the so-called large-issue houses. We specialize in the issues of smaller companies and are therefore, I think, qualified to speak of the difficulties and burdens involved in raising capital for these enterprises under existing statutes and regulations. Neither with respect to the securities acts nor with respect to the "blue sky" laws do I criticize the fundamental purposes and provisions. On the contrary I am strongly in favor of these. I would not repeal the Securities Act in toto were it in my power to do so, a view which I think is shared by most of the investment dealers throughout the United States, nor am I talking of such subjects as "competitive bidding" or "arm's length bargaining."

I regard these as incidental to the main question. But I am opposed to the almost insuperable barriers of red tape, irrelevant detail, reports, paper work, petty obstacles, vague and involved rules and regulations, which render it expensive, time consuming, and unspeakably difficult to do business in our field, where I think it is even more true than with respect to the so-called large companies.

At this point I was going to furnish an example of this, but in view of your remarks, Mr. Chairman, perhaps I will pass over it.

Senator DOWNEY. Mr. Chairman, I want to hear everything the witness has to offer.

Senator HERRING. Oh, yes. I should go right ahead, Mr. Eberstadt.

Mr. EBERSTADT. Well, I would just like to say that I recently received a letter from the Securities and Exchange Commission, at Washington, of the type mentioned and which I think is entirely immaterial to truth in securities and fair dealing in securities, but is a sample of the inexhaustible burden of detail under which we are laboring. I will read a part of the letter, and I think a part will be enough, but if you want me to go ahead and finish it I will do that, too. The letter is addressed to F. Eberstadt & Co., 39 Broadway, New York City, and is from the Securities and Exchange Commission:

> After considering the explanation contained in your letter with respect to the reporting of the sales of the above-named securities reserved by you for sale otherwise than as syndicate manager, I find that if the information shown in your reports on Form X-17A-3 for December 7, 1939, is correct, your reports on Form X-17A-1 for the same date were filed incorrectly. For example, in your report on Form X-17A-3 for December 7, 1939, with respect to the preferred stock, you showed in the answer to item 3 (a) (i), that you reserved 650 shares of that stock for sale otherwise than as syndicate manager, and that Hawley Huller & Co. reserved 10,000 shares of that stock for sale otherwise than through the syndicate manager. Moreover, in the answer to item 3 (c) (ii) you showed that prior to the close of business on December 7, you allotted 9,350 shares of the stock to persons invited to become members of a selling group. Consequently, pursuant to subparagraph (a) (3) of rule X-17A-2, you should have filed a report on Form X-17A-1 for December 7—[Laughter.]

Senator HERRING. Mr. Chairman, there is the call to the floor of the Senate. We will have to go over and vote. It is a record vote, and we are needed over there.

Mr. EBERSTADT. Well, I do not wonder, Senator Herring. [Laughter.]

Senator DOWNEY. Gentlemen, I feel very unhappy at not being able to give more of my time and attention to you while you are presenting this matter, but I have to withdraw now.

Senator HERRING. We will be back in 15 minutes.

Senator HUGHES. I wonder if we cannot pair.

Senator HERRING. I do not think so in this case because we are all voting the same way.

Senator DOWNEY. I hope you gentlemen will not think we are lacking in courtesy.

Mr. EBERSTADT. Oh, no. The Nation's business must go on.

Senator DOWNEY. Well, this business must go on, too.

Senator HUGHES. I will remain here, and if they need me they may call me on the phone.

Senator DOWNEY. I am reading all of the hearings—I want the witness to know.

Mr. EBERSTADT. Shall I go ahead, Mr. Chairman?

Senator HUGHES (presiding). Yes; the other Senators will return as soon as they can, but I want to proceed with the hearings and get through with them.

Mr. EBERSTADT. To the extent that they are still alive, the main sufferers from this situation have been the small local investment dealers, who in the past performed a service of inestimable value in

raising funds for new local enterprises. The loss of this source of new capital has been, in my opinion, a serious deteriment to the country as a whole. The result is that underwriting business more and more has been confined to large companies and has been increasingly dependent upon what is called Wall Street, which, generally speaking, is not equipped to finance companies of small size.

It may be said that investment trusts have not in the past been an important factor in the furnishing of capital to small companies or to new industry, and in reply I would ask, "What field has?"; and this is one of our main problems today. I am convinced from our conferences on this bill with the Securities and Exchange Commission that nobody more than the chairman of this Commission would welcome the entrance of investment trusts into this field, but I can assure you that in my opinion under existing laws and particularly under the bill before you for consideration, this is not and will not be possible.

Senator HUGHES. State that again, please. What will not be possible? There is some confusion in the room and I lost that.

Mr. EBERSTADT. The raising of new capital for new or speculative enterprises or creating ventures.

Senator HUGHES. I wanted to be sure that that was what you said.

Mr. EBERSTADT. Accordingly I recommend to your committee that this bill be given further consideration and study from the point of view of presenting a bill which, on the basis of experience in securities legislation and regulation to date, will correlate and integrate into as simple, definite, and concise form as possible the various provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and this legislation, so that as a result of such consolidation and simplification many of the barriers which now exist in the way of the free flow of capital may be removed without departing from the fundamental basis of strict truth and fair dealing in securities.

That is why I am against any bill at this time.

I have stated that I am against this bill at any time, my objection being based not on the purposes and objects of the bill, with which, generally speaking, I concur, but from conviction based on experience that, if passed in its present form, the bill would result in the same type of confusion and stagnation in the investment trust field as now exists largely as a result of present and similar legislation in the new capital field.

This bill is complicated, vague, and indefinite throughout. It goes 'way beyond what is wise and reasonable and would be definitely injurious not only to the investment trust business but through the investment trust business in greater or less degree to much other business. Many, if not most of the important provisions in the bill are subject to broad interpretation, addition, modification, or even repeal in toto at the discretion of the S. E. C. If passed, it would be simply another platform on which would be erected a monument of vague, unknown, and unpredictable rules, regulations, reports, and so forth.

Regulation is not of itself an easy cure-all for all ills of the investor. May I invite your attention to the fact that stockholders and depositors in banks in 1933 were stockholders and depositors in regulated institutions. While I have made no study or estimate of the amounts, I should doubt whether their losses were not many times the losses of security holders in investment companies. The same remark is

applicable to the holders of the securities of railroad companies which have been under regulation for many years. In my opinion the principal cause for losses of those interested in banks, railroads, and investment trusts, just as in real estate and practically every other field, was from conditions and not from occasional dramatic crimes. I have noted with interest that the most astute and experienced businessmen when they set up personal trusts do not confine their trustees to so-called "legal investments."

So much for my general remarks on the bill under consideration Others have and will speak to you in detail about other particular sections. I will confine my detailed comment to sections 10 and 1 of the proposed legislation and in the first instance, address myself to [section 10,] headed "Affiliations involving conflicts of interest."

Regardless of the extent to which conflicts of interest may or may not have been the cause of abuses in investment trust practice or losses to investors, I feel that such conflicts are contrary to good business ethics, favor their elimination and would welcome the inclusion in any bill of a plain, simple, and final statement without discretion, regulation, red tape, or anything else of the sort, definitely putting an end to such conflicts of interest.

There is, however, only one practical way and one effective place to accomplish this and that is by providing that a majority of the board of directors of an investment company shall be independent not only of manager, underwriter, and broker, but also of each other. No matter how long or involved the provisions of any statute may be, or how broad the regulatory power conveyed therein, nothing short of this would appear to us to accomplish the objective, and any effort beyond it accomplishes nothing further except nuisance and expense. It is in the light of this principle that I wish to comment on the particular paragraphs of section 10.

[Section 10 (a).] As the suggestion which I have already made goes somewhat further than the language of this paragraph, we obviously have no objection in principle to this paragraph, except that we feel that the exclusion of a broker as one of the independent majority is not justified and tends to limit the already restricted field of available directors. One broker member on a board not affiliated with any of the other directors, might well be advantageous through contributing information on prices, markets, and so forth.

Section 10 (b) is an exception to 10 (a) covering primarily a special and limited type of situation with which we are not concerned.

Section 10 (c) excludes from the board of an investment company any investment banker or broker if he is a director, officer, or manager of an investment company not in the same system.

I can see no merit in this provision, provided a majority of the board are independent and without affiliation to each other. On the contrary, it seems to me that it might be definitely desirable so long as there is an independent unaffiliated majority, to have one member of the board, even though an investment banker or broker, who might also be associated with some other investment company, from whose experience and deliberations in such other situation, definite benefit might flow. I see no particular virtue in complete isolation of thought and action of one investment company from another. In the investment field, as in every other field of human affairs, exchange of opinion and discussion should be, and usually are, productive. Naturally,

interlocking of directorates, if carried to the extreme, may not be desirable, but such a situation cannot exist where each member of the majority of the board must be independent of affiliations with each other and the minority.

Section (d) provides that the board of an investment company cannot employ as "investment officer" or "manager"—which, so far as I know, is a new creation in this field—any officer or manager of another trust not in the same system, any bank director or officer, any person who regularly acts as broker, any principal underwriter of an open-end trust, or any one affiliated with any of the foregoing. While there might be some question as to the same people managing two like competitive trusts, I can see no reason why the same group should not manage two independent and noncompetitive trusts.

Senator HUGHES. You say that is a new office or a new creation?

Mr. EBERSTADT. An investment officer, so far as I know, is an an entirely new creation. I think that is the brain child of our good friends. So I am not familiar with the habits and characteristics of investment officers. According to the definition in the bill, he looks very much like what we are accustomed to call an order clerk.

For example, the investment policy of Chemical Fund requires high-grade, seasoned stocks. It is not, and by the nature of its constitution probably never will be, engaged in underwriting or in financing of new or speculative enterprises. On the other hand, there are tremendous opportunities for development of new fields in the chemical business. It is a fast-growing industry offering sound and profitable opportunity for investment. From every economic and social point of view, it seems to me its development should be encouraged. I can see no sound reason why the fact that we are managers and underwriters of Chemical Fund should conflict with, or exclude, our organizing any such other enterprise. I feel that our acquaintance in the chemical industry through Chemical Fund particularly qualifies us for the organization of a more speculative fund in that field, if we ever desire to do so, yet by the language of this bill, we would be precluded from doing so with the result that a certain portion of capital is prevented from flowing into industry in this important and promising field. Similarly, and in spite of our rather extensive experience in the field, we would be excluded from forming an investment trust to underwrite new or speculative enterprises.

With the second section which prohibits a director or officer of a bank from being a director of an investment company, I also differ. Anyone who has faced the task of seeking directors qualified by ability, experience, and character to serve on an investment company, knows that the field is limited, that such directors are difficult to get, and that among the best qualified to act in that capacity are officers and directors of our banks. It is with great regret that I would see them excluded from acting on an investment company board, and I see no real conflict of interest, bearing in mind that this comment, as well as my other remarks addressed to this section 10 are on the assumption of the existence of an independent majority of the board not affiliated with the managers, the underwriters, or each other.

The third section excludes any person who regularly acts as broker for such registered company. On this subject, I wish only to repeat what I stated with respect to bank directors.