On section 6, which deals with the exemptions, there was no difficulty up to subsection (c) on page 13, which contains the much-discussed provision to the effect that the S. E. C. has the power completely to exempt anybody, any security, any company, any time.

I think Judge Healy would like to say a few words about that subsection.

Senator HUGHES (presiding). All right, Judge.

Mr. HEALY. One of the problems was to try to determine what companies ought to be subject to this statute and what companies ought not to be. It was not an easy subject; and if you will look at section 3, at page 5, in subdivision (b) and the following divisions, and then look at the exemptions in section 6, you will see that there are a good many companies, which, either by exemption or by exclusion, according to the definition, are not subject to the act.

Due to the experience that we had under the Exchange Act, it seemed possible and even quite probable that there might be companies—which none of us has been able to think of—that ought to be exempted. Therefore, this section was written.

Of course, the Commission would not go to the trouble of getting up its recommendations and undertaking to defend them, and then turn about—as one witness suggested might be done—and let out everybody and proceed to enable everyone to be exempt from the provisions of the act and from the operation of the act. That would not make sense.

So far as we are concerned, this was put in here, not to give the Commission additional power or prestige or anything of the sort, but simply so that we could deal with the unpredictable situation where a kind of company turned up—a kind such as none of us had thought of—that ought not in fairness be made subject to the statute.

There are various ways in which that situation can be handled. The committee can completely throw out that provision; and if the committee does so, such a procedure probably would relieve the Commission of the burden of passing upon a good many cases that will not have any merit, and we shall no shed any tears over it; we can stand if it if the industry can. I doubt very much if the industry can.

The second thing that might be done is to pass it in its present form.

The third thing that might be done is to rewrite it and to make the standards somewhat tighter. The standards that are in here, I am convinced are legally sufficient; but whether as a matter of policy they are sufficiently definite and whether they are spelled out with sufficient clarity, I would not attempt to say.

Of those three courses, I think the one that I would be most willing to recommend would be the third course. However, we shall find no fault whatever if the section is completely stricken out. It does not help us any; it is simply designed, as I said, to give us the opportunity to let out a company that in fairness and in justice should not be subject to the act.

Senator HUGHES. If you left them out, Judge, that would leave them to the wording of the statute and the regulations that are prescribed by the statute, and there would be no flexilibities?

Mr. HEALY. If you struck it out completely.

Senator HUGHES. Yes.

Mr. HEALY. And then if some company came along—a company of a type which none of us has heard about or been able to think

about—which in fairness ought not to be subject to this statute, we would not be able to do a single thing for it. I think it would be very unfortunate if the industry were made subject to too rigid a statute; and if that occurred as a result of the complaints and criticisms by the members of the industry themselves—having helped to put themselves in that position—it certainly would be somewhat shocking if they later criticized the act as being too rigid. If it is too rigid in this respect, it seems to me that it would be their fault.

That was based on actual experience of the Commission; and I should like to repeat what I said in the opening: That in the early days of the Exchange Act if we had not had rather liberal powers of exemption, I do not believe we could ever have registered the stock exchanges of the country and the thousands of shares and the thousands of securities that had to be registered on those exchanges, without serious interruption of business. The fact that the Commission had such liberal powers of exemption did help us and did help the exchanges over several rather rough spots.

Now I should like to speak for just a minute also about subsection (d); and again I am not going to try to defend the language, but I should like frankly to lay before the committee what our motives were in suggesting that section. It is based on some actual experience that we have had under the Holding Company Act; and that experience is this: There is a certain very large corporation in this country whose major activities are not at all in the utility field, but they do have investments in utility companies—investments of such a size that the figures are very large and impressive, taken by themselves, but in comparison to the total assets of the corporation are somewhat minor. That corporation is very much averse to being known as a registered holding company; and the nature of its business is such that my feeling is that they are entirely justified in taking the position that they do. There is not the slightest reason why the S. E. C. should have any jurisdiction over the activities of that particular company outside of the utilities field.

The result which should ensue from that situation is this: That particular company should be wholly exempted from the Holding Company Act, except as to the dealings between itself and its utility subsidiaries. I do not think there is any difference of opinion between the Commission and the industry, with respect to that.

Now the question is, How to accomplish it. As the Holding Company Act is written, it is extremely difficult to give the company the necessary exemption. Some of the lawyers claim—I do not know whether they are right about it or not; I have not given up hope of working out the situation—but some of the lawyers on our staff advise us that we cannot give that company an exemption unless it registers. In order to obtain the exemption—which we have not the least desire to withhold—they would have to register and then get exemption from certain sections of the act. In doing that, they would immediately get the label of a holding company—which they ought not to have.

In the face of that experience, we thought that something of the same sort might possibly be encountered somewhere along the way, in connection with investment trusts; and if there were a company that ought to be subject to some of these provisions and not be subject to others, then we thought that this kind of provision, which is not

in the Holding Company Act, would enable us to work out the desirable result: that without registration they could become subject to only those sections of the act to which they ought to be subject.

These are our motives; I think the motives are all right. My guess is that the language is appropriate to accomplish that. If it is not, it can be rewritten. If the committee and the industry do not care to put the Commission in the position, under this act, which will permit of more flexibilities than permitted by the corresponding provisions of the Holding Company Act, then I say again that the Commission can stand it if the industry can stand it; but I do not think the industry can stand it.

That is all I wanted to say about that.

Mr. SCHENKER. With respect to [section 7], as I recall, there was no specific comment regarding its provisions.

In considering [section 8] relating to the registration of investment companies, there was some expression of opinion with respect to one of the provisions contained in the section. There was some criticism of subsection (b) (1) (C), on page 18, which deals with the characteristics, amounts, and relative amounts of securities and other assets which the registrant has acquired and proposes to acquire in the course of its business. I think that comment was made by Mr. Paul C. Cabot.

The fact of the matter is that, as I understand it, it is precisely the language of the registration statements under the 1933 act. That does not bind them as to what they may do in the future. It just provides that you must state what your present intention is with rsepect to what investments you are going to make—characteristics, and so forth. Well, that is the substance of the 1933 act.

As I indicated during the affirmative presentation, we have made an effort to eliminate duplication; and if he filed under the 1933 act or the 1934 act, he could use those documents in his registration under this act.

Judge Healy will discuss section 9.

Mr. HEALY. In connection with section 9, I should like to pursue the same method of presentation that I did in commenting on the other sections, and I should like to tell the committee what we were trying to accomplish.

What we were trying to accomplish, in view of some of the things that happened to various trusts, was to get rid of persons with criminal records, persons who were under injunctions from courts of competent jurisdiction for improper practices in connection with securities. We had no other motivation. In suggesting such provisions, we were not trying to regiment anybody; and we were not, under the guise of getting information for this purpose, laying any plots to inquire into private affairs of directors and underwriters—affairs which admittedly are none of our business.

Our purpose was simply to try to get that type of person out of this business—where such persons ought to be out of it. At the same time we were trying to make provision for the case of a man who within 10 years might have been guilty of a crime, who nevertheless had made a come-back and regained the respect of his fellowmen, and who should not in fairness be subject to the prohibition. If that objective is accomplished in some other manner, I see no reason why it should not be.

Therefore, if the proposal is that in section 9 you write a prohibition that a person who has been convicted within 10 years of this sort of

crime or a person who is subject to this kind of an injunction shall not occupy one of these positions specified in this section, I think that might be a very sensible solution of it. However, if you do that, having put that strict prohibition into the statute, then I suggest that you append to it another section providing that with respect to any person who finds himself in that unfortunate position, if he can establish before the Commission—the administrator of the act—that nevertheless it is not against the public interest for him to occupy that position, the Commission may then permit it; I think that may be desirable.

Mr. SCHENKER. There is just one further aspect on that subject: Just in order to get the record complete, I should like to introduce a short memorandum which contains a very succinct analysis of the banking laws of some of the States. We made an analysis of the banking laws of 27 States, and this memorandum contains the provisions with respect to registration of officers of banks, and comparable provisions; so that if the committee desires to follow the suggestion of Mr. Paul C. Cabot, who said he was in favor of registration of officers and directors, you will get some idea of what the banking law is in the various States.

Senator HUGHES (presiding). Very well; it will be received and inserted.

(The memorandum referred to, dated April 17, 1940, is as follows:)

MEMORANDUM ON REGISTRATION OF BANK OFFICERS AND DIRECTORS UNDER STATE BANKING LAWS

The banking laws of the following States have been examined: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New York, North Carolina, Ohio, and South Dakota.

Two States, South Dakota and Nebraska, provided for registration and approval of officers in express terms.[1] A third State, Colorado, provided for approval of officers (and by implication for registration).[2] A fourth State, New York, provided for registration of director of savings banks in a limited fashion.[3] However, in addition to these four States, three States, Arkansas, Idaho, and Iowa, provided that the banking authorities might report to the board any officer he finds to be incompetent, reckless, or dishonest and if the board fails to remove the officer the members are liable for consequential loss.[4] An eighth State, Georgia, provided for the immediate removal of an officer or employee by the banking authorities if it finds him to be dishonest, incompetent, or reckless

[1] Sec. 6.0317 of the South Dakota Code of 1939 provides that, within 5 days of election of an officer, the election shall be reported to the State commission "together with such other information as may be required by the rules and regulations of the commission." If the commission refuses to confirm the election of the officer, the office shall be vacant; and, if the officer is permitted to act without approval, the bank may be liquidated.

Nebraska requires (Compiled Statutes, 1929, ch. 8-166) that the executive officer shall be a person of "good moral character, known integrity, business experience, and responsibility; and be capable of conducting the affairs of the bank on sound banking principles"; and it continues that no person shall act as an active executive officer without a license from the department which may revoke the license if the business is conducted in an unsafe manner. The failure to have a license is a felony, and the department may make and enforce reasonable regulations and prescribe forms to carry out the intent of the section.

[2] Colorado provides (Statutes of 1935, ch. 18, sec. 12) that no one shall be an officer, director, or employee, if convicted of felony or of violating the banking laws of any State or of the United States; and the banking commissioners shall have the power to refuse approval of such person for any position in the bank.

[3] New York provides in sec. 246 of the Banking Law of 1938 that the election of a trustee to a savings bank shall be reported to the superintendent within 10 days together with name, address, and occupation; that such trustee may not have been bankrupt and must not have previously made a general assignment to creditors, must be a citizen and a resident of New York, New Jersey, or Connecticut; and must have no unsatisfied judgment outstanding for more than 6 months which has not been satisfied at least a year prior to his election.

[4] Arkansas provides that the Commissioner shall report to the directors of the bank any officer he finds to be "dishonest, reckless, or incompetent." If the board fails to remove the officer, they are liable for any consequential loss to the bank (Annotated Statutes, 1937, sec. 714). A similar provision exists in the Idaho Annotated Code of 1932 at sec. 25.407, and in the Kansas 1935 Annotated Statutes, at sec. 9-158.

in the management of the affairs of the bank.[5] Thus, in addition to the States of South Dakota, Nebraska, Colorado, and New York, registration may be required in Arkansas, Idaho, and Iowa in order to permit determination of general competency since general incompetence is grounds for removal as distinguished from specific incompetence in Georgia.

The power of removal is, of course, not limited to the States just mentioned.

Iowa provides that a superintendent may remove a director for failure to attend meetings (Code, 1935, at sec. 9224–C2).

Indiana (Statutes, 1933, sec. 18–220) provides for the removal of an officer or director for violation of the law or unsafe or unsound practices which have been continued after warning to desist by the authorities. If a person so removed continues to participate in the management, he is guilty of a felony. A similar provision exists in the Massachusetts law (ch. 167, sec. 5).

New York provides for the removal of an officer or director who has violated any law or regulation, or has continued unsafe and unauthorized practices, despite warning by the superintendent of banks (Banking Law of 1938, sec. 41). North Carolina in the 1939 code (sec. 223–C) provides for the removal of officers, directors or employees found by the commissioner to be "dishonest, incompetent or reckless in management of the affairs of the bank, or who persistently violates the laws or lawful orders, instructions and regulations of the Commissioner of Banks."[6]

Mr. SCHENKER. One other aspect of section 9, Senator, is this: You will notice in (4) on line 15 there is another class of persons who are required by that section to register; those are the distributors of the installment plans, and their salesmen. You must have that provision, even if you accept the modification suggested by Judge Healy that the officers and directors of investment companies may not be subject to registration; because these distributors are not investment companies, you see; and therefore the only way you can get them registered is by including a section requiring them to register.

So you would have to have a provision requiring the registration of the distributors of installment plans and their salesmen. The only reason the salesmen are included is because the installment-plan people told us, "You will do us a favor if you will register the salesman, so we shall have some of his background and if he has been thrown out of one company we shall know if he is the type of person we want to sell our securities."

In connection with section 9, Senator, the problem is not an easy one, although there is a great deal to be said for the approach suggested in having the statute read that if anybody has been convicted of a crime, he shall not be able to be an officer or director. Nevertheless, the committee may still feel—as some of the members of the staff feel—that the same procedure should be used with officers and directors as has been used with the registration of the over-the-counter brokers and dealers. In connection with the over-the-counter brokers and dealers, you have substantially a registration of the officers and directors of those companies; because if the over-the-counter broker or dealer is a corporation, information is furnished with respect to its officers and directors; and if the dealer is a partnership, information is furnished with respect to the partners. The fact of the matter is that the registration of the over-the-counter brokers and dealers is a simple thing.

In other words, I mean to say that all this talk about, "We can ask about everything that they ever did or who they are or hope to be" is

[5] The Georgia Annotated Code, vol. 5, sec. 13–603 provides that the superintendent of banks shall have the right to require immediate removal of ny officer or employee who he finds to be dishonest, incompetent, or reckless in the management of the affairs of the bank, or who persistently violates the laws or lawful orders of the superintendent.

[6] Montana (1935 Annotated Statutes, ch. 24, sec. 6014.14) provides that no one convicted under the banking laws of the United States or any State thereof may be elected a director.

just a bugaboo, Senator; because we have registered 6,000 brokers and dealers, and on the basis of that registration the Maloney Act was passed and the Maloney Association was founded.

The registration statement for brokers and dealers is simple: What is your name, address, the form of organization; are you a partnership; if you are a corporation, give the date when you started your business; who are your partners; and, then, were you ever convicted of a crime?

That is the nature of that registration statement.

Yet you heard talk here, for days and days, about how, under section blank and in conjunction section blank blank, as supplemented by section blank blank blank, as implemented by section blank, maybe at some future date somebody will get the idea he is likely to ask one of the officers and directors about his private affairs, or something! That is not the experience of the over the over-the-counter dealers and brokers.

The fact of the matter is that we have registered 6,000 brokers and dealers on a 4-page registration statement. It is an effective way of getting the information. A person files his registration, and it automatically becomes effective; and if the application shows the person is a jailbird or subject to an injunction for security racketeering, then the Commission has to institute a proceeding to revoke his registration. Do not become frightened by all that talk, Senator, about snooping.

It is just a procedure for simple registration, to get some idea of the people who are going to manage other people's money. In the opinion of some of the members of the staff, the question of which approach to take with respect to officers, directors, and so forth, is a question which deserves the consideration of the committee.

Senator HUGHES. You say there are 6,000 members under the Maloney Act?

Mr. SCHENKER. No, Senator; my recollection is that there are 6,000 over-the-counter brokers and dealers registered with the commission. Out of those 6,000, about 2,800 have already become members of the National Association of Securities Dealers. Those are the figures, as I remember them.

Senator HUGHES. I know something about that; I sat on the committee then.

Mr. SCHENKER. Well, you heard Mr. Traylor's testimony. There was a lot of talk similar to his testimony when the Maloney bill was being considered—various objections, and so forth and so on.

Today the National Association of Security Dealers is an association of 2,800 members; and Mr. Traylor is perfectly willing to entrust to that organization a very vital aspect of his business. You know as much about the background of the association as I do.

Now coming to section 10, Senator: We should like to take a little time to see what this section is about and to see what its background is and to see why we took this approach and to find out what its objective is.

This section provides:

> After 1 year from the effective date of this title, no registered investment company shall have a board of directors or an executive committee more than a minority of the members of which consists of—
>
> (1) Affiliated persons of any one company other than such registered company.

What does that mean? In substance it means that no longer should an investment trust be an adjunct to somebody else's business. We have had situations in the past of a chemical company that organized an investment trust, and the board of directors consisted of the members of the chemical company. You had a battery company which organized an investment trust, and the board of directors consisted of the people of the battery company; and you had the Hopson Associated Gas system, which controlled an investment trust—and at sometime, Senator, if you have the time, we shall tell you that story. That investment company—Eastern Utilities Investment Company—was just an adjunct to the Associated Gas system.

This section says substantially that the time has come, in our opinion, when for the benefit of investors and the industry itself these companies ought to be fairly independent institutions, standing on their own feet, and not be tied to somebody's kite, as Judge Healy expresses it. That is subdivision (1).

Subdivision (2) evidently has created a little confusion in the minds of some of the witnesses. Subdivision (2) states—

> The majority of the board shall not consist of persons who regularly act as manager, investment adviser, broker, or principal underwriter of or for such registered company, or affiliated persons of such persons—

Some witnesses have stated that that paragraph has eliminated all brokers from the board and all investment bankers and that we have circumscribed the area from which you can select your directors.

Senator, the fact of the matter is that if you had a board of directors of 15 or 55, every single one of those persons on the board could be a broker. There is not one word in this paragraph which forbids brokers from being on the board. So that the 1,300 members of the New York Stock Exchange, if this bill became law, all are eligible for directorships in investment companies. Let there be no confusion about that, Senator. No matter what one may say, that is what this language provides. It does not say that brokers cannot be on the board of directors, that investment bankers cannot be on the board of directors. You can have a board of 15, and every single one of them can be an investment banker or a broker.

What it does say is that if the broker does the brokerage business for that investment company, if you get the brokerage, if you are the one who has control of the portfolio turn-over, if you are the one getting the management fees, which may depend on the type of activity you perform, then in that event the majority shall be independent of that person.

We did not even recommend that anybody who does the brokerage business cannot be on the board; there still can be a minority of people who regularly do the brokerage business.

We feel, and our study in our opinion, shows conclusively, that the person who gets the pecuniary benefits from the activities of the investment trust should not be in complete control of those activities. If he is getting the brokerage business, all we say is that there ought to be an independent board there to take a look to see what is going on. Now, Senator, this is not a novel idea. The fact of the matter is that Mr. Bailie, when he testified for us—and he was very helpful and followed our investigation very carefully—had a prepared statement which he read at our hearing. This statement was printed and, as Mr. Quinn said, was sent out to 45,000 of his stockholders.

I do not know if this is still the fact, but I believe that Mr. Bailie is still the chairman of the board of directors of the Tri-Continental Corporation, with which Mr. Quinn is associated. I may be wrong about this, but I think I asked Mr. Bailie whether he submitted it to his board of directors before he read it at our examination; in any event, the corporation printed the statement and sent it out to its stockholders.

Mr. Bailie says unequivocally in this statement which is captioned "Democratization of Management":

> The interesting suggestion has been made that present corporate practice in investment companies be democratized, to make the small shareholder's voice in the choice of directors less perfunctory and more effective. The value to be obtained by having such stockholders take a real and continuing interest in their company's affairs would be great and we are in favor of this objective.
>
> There are certain steps in this direction that we believe could be taken to advantage:
>
> "(1) By the practice of providing that a manager of the board be independent of the sponsors or managers."

That is the situation today in Tri-Continental.

Now, Senator, you have heard some talk that the effect of this provision is going to be that a person who bought Lehman Brothers management may be compelled to accept somebody else's management; that the Government is trying to sell the stockholders down the river to somebody else. Just do not be frightened about that, Senator. The fact of the matter is that Tri-Continental Corporation is known throughout this country as a J. & W. Seligman Co. company, and it has an independent board of directors. Everybody in the country knows that State Street is a Paul C. Cabot & Co. management, and they have an independent board of directors. Everybody in this country knows that National Investors is a Fred Presley Company and he has got an independent board of directors. There are other companies in a similar situation, and I can give you company after company like that. So that the fact that the person who is really giving the investment advice does not control the board does not mean that he is not giving investment advice to the company. The only thing it means is that there are going to be some members on the board of directors representing stockholders, to have some participation in the management of the company.

Now, I would like to just subdivide this problem into three parts, Senator, if I may. You will notice it provides that a majority of the board of directors cannot be persons who act as management investment advisers, brokers, or principal underwriters; and I would like to discuss the broker aspect, first, and then discuss the manager aspect, next, and then the principal underwriter aspect next.

If I may go back for a second to the brokers. The bill provides that the majority of the board cannot consist of affiliated persons. What is the significance of that provision? If you have a board of directors on A investment company, it means a majority of the board of directors of B investment company cannot consist of directors of A company. There is nothing here that prevents a minority interlock; and I thought after we discussed this with the industry we had made a very substantial concession, because, Senator, we feel, as many people in the industry feel, that even to have one interlocking director creates problems.

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You have had witnesses here who said they had been on the boards of other companies, and they felt in their experience that it did not create any problems. I think Charles Francis Adams and Roger Amory, and so forth, testified to that effect. But, Senator, I would like to read a letter, which is in evidence in our public examination, from Mr. Paul C. Cabot to Mr. John C. Greer, Jr., dated January 11, 1929. Mr. Cabot is closely associated with State Street Investment Trust, and he has an independent board of directors [reading]:

> In accordance with our conversation of yesterday, I am writing to confirm my ideas as expressed at that time in accepting a position as director and member of the executive committee of the National Investors Corporation.
>
> It is my understanding that the following ideas are acceptable to you and the other officers and directors:
>
> In the first place, it is understood that in becoming a director I am only assuming those responsibilities and duties that normally fall to the lot of any other director, and that as such I am not expected to sell or recommend for purchase various securities that may be issued from time to time.
>
> In the second place, as I explained to you, I believe it should be clearly understood that my first duty is to my own companies and trust, and, secondly, to the present two funds of the National Shawmut Bank, and in the third place, to you.

He was on the board of directors of State Street: he was a director of the National Shawmut Bank Investment Trust, and they asked him to go on the board of directors of National Investors. Paul C. Cabot evidently had plenty of difficulty with such interlocks because he took the pains to put his position in writing, and said: "I want to warn you that my first duty is to State Street. Then I owe my second duty to the Shawmut Trust, and the third to you. If you want to take me on that basis, all right."

So that the problem is created simply by the fact that you are on two boards of directors of companies in the same business, buying the same securities and engaging in the same activities. Necessarily there are problems.

Now, we did not recommend to this committee that a person cannot be on the board of directors of more than one company. We even permit the interlocking of a minority. We only said that when it comes to interlocking majority of directors you certainly have problems, and it was our recommendation that that be not permitted.

Let me go back to the brokerage business for a moment, if I may, Senator.

What are the problems in connection with the broker relation with an investment company? The ordinary investment company, Senator, is nothing but a large discretionary account. There is no limitation on what securities it buys, how many securities it may buy, when to buy them, how often to buy them, how often to sell them. But if you have a situation, as you have in some instances where the board of directors consists only of partners of a brokerage firm, then what have you got? You have got a discretionary account.

The New York Stock Exchange, in connection with discretionary accounts with brokerage firms, where the problem, in my opinion, is not even as acute as an investment company's because you are dealing with an individual customer who can see what is being done in the account, takes pains to set up protective features in those accounts. The only thing we are saying is that a similar procedure ought to be followed in connection with an investment company. If a person or his firm is the broker for the investment company, then he cannot control the board.