company their aliquot share of their stock interest in the company.

But we will elaborate on that a little bit when we come to it, Senator.

Now, subsection (b) on page 29, in substance says that a diversified investment company can do underwriting, provided the maximum amount of underwriting it does is in the 15 percent reservoir.

On that aspect, Senator, while we were defining different types of investment companies, we made provision for the creation of a class known as the diversified investment company, and, as the name signifies, the emphasis is placed on diversification and investment as distinguished from trading.

In order to make available part of the funds of the diversified investment company to industry we said that with respect to 15 percent of your assets you can go into underwritings. If they feel they can make money by furnishing capital to industry they can do it up to the extent of 15 percent of their total assets.

When we get above that, Judge Healy and the Commission had the feeling that underwriting is an entirely different business from investment. It is more speculative, and if you permit a greater diversification than 15 percent, you are subjecting people to the risks of the underwriting business.

Subsection (c) says that it is unlawful for any registered investment company to purchase or otherwise acquire any security issued by, or any other interest in the business of another investment company.

That is a flat prohibition. In the future no investment company shall buy the securities of another investment company, with this exception. You may meet situations where you have a small fund; the management is not doing a job, and it wants to relieve itself of liability. At that particular moment, if there were no liquid assets, or because of the depressed condition of the market which might then prevail, it might be an injustice to these people to liquidate the trust at that time.

The exception is for the type of situation where one company is going to take over another investment company and make it one unit. It makes provision for the situation where one company may want to consolidate with another company. But we will discuss those provisions later.

I think this ought to be made clear. This section does not say that in every situation at the present time where one investment company owns another it is incumbent upon them to dispose of their interest in the other investment company, or that they collapse the structure and become a single unit. Pyramided structures of investment company systems in existence at the present time are not touched.

There was a great deal of sentiment for cleaning up that type of situation, and if you will bear with me one moment I will just show you what the possibilities are and I will try very succinctly to illustrate some of the abuses that have been created by virtue of that.

Senator TAFT. I would be inclined to agree with the bill on that, myself. I do not see any reason for pyramiding them.

Senator WAGNER. There are others of us, you know. We may want to know something about it.

Mr. SCHENKER. I want to show you what is possible, Senator, when you permit that. If you will look at the top of this exhibit [indicating] you will see what the set-up was in the first instance. I thought it was an Ohio company, but it was a Detroit, Mich., company. They were first set up really as separate and distinct corporations. Each one was organized separately. In 1930 you find two separate companies, having no connection with each other, and then one being pyramided on the other. The following year you have one separate company, and then one top company owning two of the others. In 1932, the following year, they had the arrangement set forth. In 1933 they began a complete circle, the American Capital Corporation owning the Pacific Southern Investors, Inc., which, in turn, owned Investment Company of America, which, in turn, had an interest in the American Capital Corporation.

Then the following year the circle straightened out and went into a straight line. In 1935 it took a different puzzle effect, and in 1936 it has taken another puzzle effect.

Senator WAGNER. Can you tell us the reason for all of these organizations? You investigated this matter, did you not?

Mr. SCHENKER. Oh, certainly. The reason is that by doing this you can solidify your control of the particular situation. They could control the one company. And it has not been unusual, as we have shown, that they buy control, in the first instance, by using borrowed money and reimburse themselves out of the assets of the investment company by selling out dubious securities. They also 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 to insiders.

In that particular instance the management sold its management stock for a very substantial amount, and control was turned over to somebody else. 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 belonging only to senior security holders, and in that way they can build up a very substantial pool of public funds which they control at little or no investment by themselves.

I thought you might be interested in taking a look at the Central States, which is the company that Mr. Harrison Williams controls. This is approximately at the present time—December 1939.

In this situation you see Central States Electric Corporation has assets of $13,000,000. It has got outstanding 5 percent convertible debentures due in 1948; 5½ percent convertible debentures due in 1954; 7 percent preferred stock; preferred option dividend series, convertible preferred stock, and common stock. That company is superimposed on other investment companies which also have bank loans. It is a complicated capital structure, Senator. Not only do you have pyramiding, but you notice that the Central States Electric Corporation has a 31 percent interest in Blue Ridge Corporation. The Blue Ridge has an 8 percent interest in Central States Electric Corporation. You find that the Central States Electric Corporation has a 7 percent interest in General Shareholding Corporation, and General Shareholding Corporation has a 3 percent interest in Central States Electric Corporation.

Senator TAFT. Are these five all operating companies?

Mr. SCHENKER. That [indicating on chart] is the holding company itself.

Senator TAFT. The others are just an investment trust?

Mr. SCHENKER. Yes. What is the effect of that, Senator? Their principal investment is in the North American Co. You are not only pyramiding capital structures, but you are pyramiding the management fees. I do not want to appear brusque, Senator, but it seems to me that a situation like this just does not make sense.

And not only that, Senator, but take a look at the Central States Electric Corporation. Mr. Williams' original investment in this situation, as I recall it, was $3,000,000. By pyramiding investment company on investment company and operating pools in all the underlying investment companies, in the course of the general market increase, his shares of stock, after he got back his original investment and dividends, reached a market price of $687,000,000.

Senator WAGNER. As the result of what?

Mr. SCHENKER. Of course that is leverage—putting leverage upon leverage upon leverage. October 1929 rolled around, and as I recall it, he sold about $45,000,000 on the way down, and his interest was worth $27,000,000.

The curious thing is this: That at the time when his stock was worth $687,000,000, he indirectly controlled a utility system with a billion dollars of assets. Today, the stock has no asset value at all, it is practically all under water. If you will notice, the Central States Electric Corporation, with assets of $13,000,000, has $26,000,000 of debentures outstanding. The debentures are only worth 50 cents on the dollar, and the preferred stock is under water. But Mr. Williams today has an influence in a utility system worth $3,000,000,000.

That is one of the major problems in connection with investment companies.

Senator TAFT. Is the common stock in the hands of the public?

Mr. SCHENKER. The common stock in Central States is mostly owned by Mr. Williams. The public owns the senior securities, the debentures, and the preferred stock.

Senator WAGNER. How much did the public put into this investment, approximately? The larger share, of course?

Mr. SCHENKER. $250,000,000 of the public's money went into the whole system.

Senator WAGNER. When that money was sought what were the representations that were made as to what was to be done?

Mr. SCHENKER. The usual representations that he was going to invest it in utility stocks.

Senator TAFT. When they went into this, how did they come out?

Mr. SCHENKER. If they got out before October 1929, they did very, very well. If they stayed along with him, they did not come out very well.

Senator TAFT. How was Mr. Williams making all his money out of common stock without the other people making some?

Mr. SCHENKER. He at that time owned 90 percent of the total outstanding common stock of Central States. He did not know the fancy word "leverage." He had been in the bicycle business, and he is a most charming and interesting man. He figured out that if he issued senior securities he would have the finest margin account in the world. The debenture holder puts up the money and is

entitled only to the return of his principal and interest, which corresponds to what the broker is entitled to in a brokerage firm. He had this big pool of money of the public with which he could speculate.

Of course if you are under water and your margin account is at the broker's, you will get a telephone call to put up margin; but no matter how much Mr. Williams is under water in the Central States, nobody can call on him to put up more margin.

That is one of the things that motivated us in putting a provision in the bill that somewhere along the line there ought to be an equitable distribution of voting power.

The people who really own Central States Electric Corporation have actually no voice in it. The income of the company is not sufficient to meet the interest requirements on debentures. Mr. Williams is gradually liquidating that company by selling its portfolio securities to meet interest payments, and the debenture holders are really getting their own money back.

Senator TAFT. He will lose everything he has in Central States if he liquidates.

Mr. SCHENKER. If he should liquidate that company today he would not get a dime out of it. Yet he is running that company and has some influence in this utility empire.

That is one situation which we felt merited consideration, and that is one of the reasons why we put in this provision about the redistribution of voting stocks. These debentures do not have any touch-off clause. They can go down to nothing.

Senator FRAZIER. Have no what?

Mr. SCHENKER. Touch-off clause. Usually a debenture has a provision that if the assets go below a certain percentage of the total amount of the debentures outstanding, then there is a default and the debenture holders can take the company.

I say, that is one of the numerous instances that persuaded us to make provision that the persons who really own the company, at least ought to have a vote in some instances.

Now, what can be the result? What do we mean by this high leverage stock? By "leveraged" we mean that phenomenon which, when the total assets of the company increase a certain amount, the asset value of the common stock increases in a greater proportion, because all of the increase, after a certain point, goes to the common stock.

What is the effect of that? I am not saying this about Mr. Harrison Williams, because I have never met a more gracious and cooperative man in my life. I examined him for days. He was very helpful. But the only way he can make any money, or a person in a similar situation, is to take speculative ventures, because if he can make a profit in the first instance, the profit will accrue to the greatest extent to the common stock. To whom does he owe the primary obligation? Every time he makes an investment, you have got to ask the question, Is it good for the common stock holder——

Senator TAFT (interposing). I do not quite get the point. What you are now saying is that in an investment trust the preferred stock holder should have more voice in the management? There is no management stock; this whole 10,000,000 shares of stock—common stock—has voting power?

Mr. SCHENKER. That is right, Senator.

Senator TAFT. I mean, what is your suggestion as to the remedy for the situation?

Mr. SCHENKER. The remedy is, Senator, not a simple matter, and because of the complex nature of the problem, we could not make specific provision for that in the statute. For instance, if the preferred stock passes its dividends twice, the preferred stock holder should have a vote, and if the common stock has had no asset value, the preferred stock holder can say, "You are gambling with my money. I should have something to say with respect to my investment."

The debenture holders may have said, "Mr. Harrison Williams, you have had use of our money for many years. You could have made millions. Don't you think we should have some representation in the management?"

We have a section in the bill which says something about that. I have a little difficulty with the language, but the underlying philosophy is that there comes a time when the person who owns the stock should have something to say in the management of it. That is the whole purpose of the section which says that there should be an equitable redistribution of voting power. That is one of them.

The other one is where a person gives himself stock at 50 cents a share and raises $30,000,000 from the public. The whole industry says that should be abolished, but the fact of the matter is that such type of stock is outstanding. It is not in the hands of the person to whom it was originally issued, but has been transferred from person to person. You have the situation where the public has millions of dollars in that picture, and the people who have the management stock have the majority vote in that situation.

Senator TAFT. Of course, if the company has not enough assets to equal the debentures, then it is insolvent.

Mr. SCHENKER. That is just the point.

Senator TAFT. Does that not make it insolvent?

Mr. SCHENKER. No; that is the peculiar nature of an investment company. If you are an industrial company you have a plant, you have equipment, you have service, you have help, and many charges that you must meet. An investment trust, and I am not being facetious, is nothing but a safe deposit box. It has practically no expenses. It can cut its expenses down to nothing. You can reduce an investment trust to nothing and not be insolvent. You may be insolvent, but I do not think you are committing an act of bankruptcy.

Senator TAFT. Oh, that is different.

Mr. SCHENKER. Yes; I am sorry.

Senator TAFT. I do not see why any investment trust which is insolvent should not be thrown into the hands of a receiver, just like a bank. My general approach is that they should be treated like banks and if, on a periodic examination, it is found to be insolvent, appoint an examiner and take it over and then liquidate it or not, whichever seems to be desirable. Of course, that would not be true of preferred stock. You still have the preferred stock question.

Senator WAGNER. There is no attempt, however, to limit the kind of securities that an investment trust may take. I suppose that will come next. I was going to ask you this question, perhaps because of ignorance on my part. Where is the conflict between the common stock and the debentures? For instance, the common stock does not get any dividend or profit until after the debentures have been cared for and the fixed payments made.

Mr. SCHENKER. That is right.

Senator WAGNER. So is it not to the interest of those who control the particular enterprise?

Mr. SCHENKER. I think I can explain that with a simple little illustration. I think it is important, because when we come to the capital structure section, you will see some of the reasons which motivated the Commission to say that in the future these investment companies, like a bank, should have one class of stock.

Senator WAGNER. I was asking the question as to what the conflict was.

Mr. SCHENKER. As I say, to follow through the analogy to a brokerage account, if you opened up a brokerage account with a broker, you put up the required amount and he puts in whatever is necessary. If the stock you buy in your account goes sky high, the broker does not get any part of the profit. The only thing he gets back is the advance to you and the interest. Isn't that true?

Senator WAGNER. Yes.

Mr. SCHENKER. If you visualize the senior security holder in the same capacity as the broker, then what is the situation? All the profit that the company makes accrues to the common stock holder. You find this situation. Suppose you had $100,000 of debentures outstanding and you had $100,000 of common stock outstanding. That gives you total assets of $200,000.

Now, the total assets increase $300,000, which makes your total assets $300,000. None of that $100,000 increase went to the debenture holders except in the form of interest. That means that the entire $100,000 was divided equally among the common shares which were outstanding. In a situation like that if the total assets increase 33⅓ percent the asset value of the common stock increases 100 percent.

Do you see what I mean?

Senator TAFT. In other words, the more you speculate, the more the benefit goes to the common stock holder. If you lose, the common-stock holder loses, too, but so does the other person, and he has not had a chance to make a cent. Their interest, in other words, is different.

Mr. SCHENKER. Yes.

Senator WAGNER. You mean if you sell your stock you get the profit; if you hold your stock you do not get the benefit of it?

Mr. SCHENKER. Temporarily you have got a greater value. If you do not go out and the stock market goes against you, the value will decline.

Senator WAGNER. If the enterprise makes profit, you first pay your fixed charges.

Mr. SCHENKER. That is right.

Senator WAGNER. If there is anything left that goes as dividends to the common-stock holder?

Mr. SCHENKER. That is right.

Senator WAGNER. So it seems to me that the management in control of the common stock should be interested in making profits for the enterprise. There is no conflict there, because they get their profits or their dividends only after the fixed charges are paid.

Mr. SCHENKER. That is right.

Senator WAGNER. You say, "That is right," but where is the conflict? There is a conflict if you are speculating.

Mr. HEALY. The impulse on the common stock is to speculate to get profits on the capital structure. That is the worst policy for the security holders.

Senator WAGNER. I understand, but somebody must have to buy that stock, if you are speculating with it, and there may be sufficient of it sold so that the control changes.

Mr. HEALY. Yes, but while I hold the stock I may get dividends on it after the interest has been paid.

Senator WAGNER. Exactly. There is no conflict there, is there?

Mr. HEALY. Sometimes the welfare of the senior security holders and the junior are in quite opposite directions.

Senator WAGNER. Well, I do not understand your explanation.

Mr. HEALY. We have instances here where it seems quite clear that the investment policy or the speculative policy of the trust was wholly in the interest of the common stock and not in the interest of the senior security holders. They were led into extremely speculative channels, which were good for the common stock and not good for the senior security holder.

Senator WAGNER. I may be able to clear it up in my mind by asking this question: As the value of the common stock increases, it increases because the enterprise is profitable, and if the interprise is profitable, then there is a dividend due after fixed charges are paid; is that not true?

Mr. HEALY. Yes, sir.

Senator WAGNER. Now, where is the conflict there?

Mr. HEALY. They are not always profitable.

Senator WAGNER. Do the stocks go up even though they are not profitable?

Mr. SCHENKER. No, Senator.

Senator WAGNER. All right, proceed.

Mr. SCHENKER. Section 12 (c) (2) merely states that an investment company cannot buy an interest in a brokerage firm, a distributing company, or an investment banking house. It goes further and says that if it is engaged in the underwriting business itself if engaged in that business through a wholly owned subsidiary—it is permissible to do so.

You can see the reason for that. They may not want to subject all the assets of the investment trust to the risks of the underwriting business. So we see no difficulty if they avail themselves of the corporate fiction and limit their liabilities to the amount of money they want to invest, so we say, "If you want to go into the underwriting business and want to do it through the wholly owned subsidiary, there is no difficulty with that situation."

Section 13, I think, we have elaborated upon, and that is the section which deals with the changes in the fundamental policy of the company. I do not think the industry does or can have any conflict with that approach. There may be some question, however, with respect to the sentence which says:

> The Commission, by rules and regulations or order, shall designate those investment and management policies which are fundamental, giving due weight, among other things, to the representations made in selling the outstanding securities.

and various other things.

Now, why was provision made for rules and regulations? If you would stop at the sentence, "No registered investment company shall

change any fundamental investment or management policy unless each such change is authorized by the vote of a majority of its outstanding voting securities," you would have this situation. A management may say, "Well, I am going into the commodity business. Is that a fundamental change?"

The second sentence makes it incumbent upon the Commission to tell them what a fundamental change of policy is, so that he does not act at his own risk and peril. He is apprised specifically what is a fundamental change of policy and what is not a fundamental change of policy. Then you relieve him from the danger of guessing "Am I changing the fundamental policy or am I not changing the fundamental policy?"

Frankly, as far as I am concerned and as far as Judge Healy is concerned, if the committee wants to take a blue pencil and cross out that sentence which says that the Commission shall tell these people what is a fundamental policy and what is not a fundamental policy, that is all right with us.

Then you leave them in this predicament: He wants to go into the commodity business. He wants to buy foreign paper. He wants to do a little discount business. Then he has the problem of determining the answer to the question, "Am I changing the fundamental policy or am I not?"

This provision does not tell him what he can't or can do. This provision says, "If you want to change from A to B, you can do it." This section does not say he cannot do it. The only thing he has to do is tell his stockholders and say, "Please take notice. I am going to change my fundamental policy, and because I am going to change my fundamental policy, I have got to have your approval."

The only effect of that situation is that we will assume the burden of saying whether or not this is a fundamental policy, which will immediately relieve the management of that trouble and annoyance.

As I say, if the industry has difficulty with it, you can just blue pencil it out.

Of course, the committee must be conscious of the fact that we have a provision in section 36 (c), on page 78, which says this:

> No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

Now, that provision is a duplicate of what is in all the securities and exchange acts, and it really, in substance, requires willfulness and intent. If you act in good faith and if you violate a rule or regulation, there is no liability.

Senator WAGNER. May I ask a question there about something I want to understand? You speak of fundamental policy. Now, how do you ascertain what the fundamental policy was? Do you go to the charter and the limitations there, or how do you ascertain what the fundamental policy was that was being pursued by the investment trust, and whether it is being modified or changed?

Mr. SCHENKER. Now, the fact is, Senator, that it is provided in our registration provision, section 8, that he has to say, "I am a diversified investment company."