

We also say, as Mr. Bunker, as I recall it, indicated, that the executive officer, the person who has some control or discretion in connection with the execution of orders, should also be independent, because in many instances wide discretion is given to that executive officer. The board of directors may pass a resolution saying that "We think we have too many common stocks. Get into cash. We want you to shift from common into bonds," and leave it to the investment officer to make up his mind as to the amount of the shift and when it should be done.

All that provision says is that if you get the brokerage business you cannot control the extent of the brokerage business; you cannot control the board of directors.

There is another aspect to this problem that I think you have to keep in mind, and that is this, Senator. Investment company brokerage business is the best type of brokerage business in the world. The business consists of big blocks sold for cash; no margin accounts; the customer is solvent. More important than that, you do not need any elaborate research division to give investment advice to investment companies. You do not need any customers' men; you do not need a big office, you do not need to go out and get business. You have this large discretionary account that is considered the best type of brokerage business.

I don't want to be misunderstood, Senator. I have been in pretty close contact with everybody in the investment company industry, and they know I am not making any general charge. I think they will agree with me that in some instances, Senator, particularly in times of distress, there might be some motivation to do a little trading just to get the brokerage business.

It seems from our study that the brokerage business in connection with the investment-trust industry has always been an important element. I think Mr. Smith will discuss that in a little more detail in a few moments.

I know Mr. Bellamy and have the greatest regard for him. I know Mr. Dominick, and I don't want it to be even inferred that I am making the slightest imputation. But the fact of the matter is—I forget now what the total assets of National Bond & Share are, it is not a very big company, 10 to 20 millions—the fact is that the total brokerage paid in 10 years to Dominick & Dominick was \$1,039,266. All of the directors of National Bond & Share Corporation are partners in the brokerage firm of Dominick & Dominick. That firm sent out a letter to the stockholders of the investment company. I read that letter. It even frightened me, Senator. I could have drawn a little different letter.

What was the result? As I remember his figures he got about 200 replies, and 700 people refused to get frightened that the S. E. C. was going to ruin them. About 700 stockholders did not even bother answering the letter although they made elaborate preparations for replies: Self-addressed envelopes, and all the stockholder had to do was to answer "yes" or "no."

National Bond & Share can get Dominick & Dominick investment advice even if they do not control the board. This bill does not say that Dominick & Dominick cannot be investment advisers or cannot be the brokers for that firm. It just says that under those circumstances you have to be a minority of the board, and that the person

with discretion with respect to the execution of orders has to be independent of Dominick & Dominick.

Mr. SMITH. The portfolio turn-over of National Bond & Share was as high as 7.44 times, whereas the average for most investment companies is not over 1.25. Their turn-over record is consistently much higher. I do not say they have not done a good job, and I am not attacking their integrity, but I think, as Mr. Floyd Odum said, and as the Pecora report pointed out, brokers are in-and-out traders—point pickers.

That is one type of problem that comes from brokerage affiliation. Whether it is done in good faith or not or whether the person is a little bit unscrupulous, there is a risk.

The brokerage business is such a good emolument that investment policy in respect to the acquisition of other trusts may be guided by it. We have specific cases where it has. Even in a good trust in which I have complete faith in the management's integrity, like Tri-Continental Corporation, these conflicts may exist when it makes acquisitions. They started off in 1929 with one corporation, \$53,000,000, and then they formed another one of \$57,000,000 in August, and then in January 1930 they merged those two. During the depression they started buying up various investment companies. They got a \$3,000,000 company in 1930. Whether this was part of the transaction or not, the fact is that the old sponsor who sponsored the Wedgwood Investment Co. has since had a right to 3.76 percent of the brokerage business of Tri-Continental Corporation. That, as I understand it, is not fixed by contract, but it is one of those understandings.

Then in April 1932, they took over Investors Equity, a \$6,000,000 company. That company had been sponsored by C. D. Barney; and we find that the net result is that Barney has received annual brokerage commissions amounting to 5 percent of the brokerage of Tri-Continental Corporation.

That corporation, when it was bought out, was bought out because it had debentures outstanding and the touch-off clause was just about to operate, and the common stock was in process of being completely wiped out, and Tri-Continental Corporation was able to pick it up at a bargain.

Then in 1933 they acquired a \$2,700,000 corporation which had been sponsored by G. M. P. Murphy, and we find that G. M. P. Murphy has since received a 5 percent interest in the brokerage.

Whether or not there is a different agreement, the fact remains that all these old sponsors who have sold their trusts to Tri-Continental Corporation are getting this brokerage business; and the brokerage business is the method of compensation of J. & W. Seligman as managers of Tri-Continental Corporation. That is the sole compensation that they get, so that the J. & W. Seligman Co. have a direct interest in the size of the fund and the amount of brokerage commissions.

They are also interested in good management, I am sure.

In May 1931, Tri-Continental Corporation acquired Selected Industries, a \$53,000,000 corporation, and in connection with that C. D. Barney, the old sponsor, receives 50 percent of the Selected Industries' stock-exchange business. That is just as regularly as if there were a contract. I do not know whether there is any agreement; Mr. Bailie denied that there was; but the fact is that all these old sponsors get the brokerage business afterward.

In this case Tri-Continental Corporation paid a \$2,000,000 premium to get the control of stock of Selected Industries. In the public hearing Mr. Bailie said, "We paid that premium. We expected to make it up in management fees to Tri-Continental Corporation."

Tri-Continental Corporation provided management for Selected Industries and said they expected to make up the \$2,000,000 out of the management fees. They have not done it yet, and I think it will take many years before they do.

On June 10, 1932, Tri-Continental Corporation acquired, directly or indirectly, Broad Street Investing Co. and Capital Administration Co. They are investment companies with assets of \$6,000,000. In connection with that not only did Maynard, Oakley & Lawrence, the original sponsors, thereafter receive 66⅔ percent of the Broad Street brokerage business, on assets up to \$2,000,000, and 15 percent of all assets in excess of \$2,000,000, but they also, when they were bought out, got, if my memory is correct, about a 300-percent profit on their original investment, whereas the investors in that company had lost a lot of money. I think they had lost 40 or 50 percent.

Another company that they acquired was Globe & Rutgers Fire Insurance Co.; and we find that Hayden Stone has received 15 percent of the stock-exchange business of that company.

I am not saying that there is anything improper about this case, because I have the greatest confidence in the management of Tri-Continental Corporation; but, nevertheless, that shows that brokerage is a problem of emolument, and that it has other aspects than just the question of churning.

I would like to point out a few other risks that come with this brokerage relationship. The brokers as a group, including specialists, do about 20 percent of all the trading in the country on their own account. In other words, they are big traders themselves. Then they do the rest of the business of the country, 80 percent, as agents. So you have the same group who are big traders trading on their own account, and then they are the agents for all the other people in the country, and then they are also the agents for the investment companies. We know that in some instances their purchases and sales may have quite an effect upon the market. The fact is we know that in September of 1939 the purchases during 2 or 3 weeks, of one investment company were greater than all the odd-lot purchases combined, and they amounted to an important factor in the market.

Those are only some of the risks. You have the fact that the typical broker operates with a relatively small capital. He can borrow up to 15 times, I think it is, his original capital. He makes his money to a large extent on margin accounts. A great many brokers do. So he represents a big credit risk. He owes a lot of people and he has borrowed that money back again from banks, so he is a risk from that point of view. We have had several examples, and I think I have already cited some examples, of brokers who were up against it and had to have money quickly, and they resorted to some direct or indirect transaction to save themselves.

Then, finally, I think there is another reason for having fairly strict supervision of brokers, both on the operating level and on the board level, and that is the fact that most of these brokerage houses are not only acting as investment brokers, but a lot of them are acting as investment counsel, and they are passing out the same information that they pass out to the investment company. They

are passing it to their brokerage clients and to the clients of the investment counsel service.

As I analyze the situation of the brokerage relationship with the investment company, they are engaged in exactly the same business, and the only question in my mind is whether we have gone far enough in providing for an independent majority and some independent person at the operating level where the broker wants to be the manager.

In connection with the acquisition of Broad Street, Maynard, Oakley & Lawrence got—I do not know whether it was a 300-percent premium or a 300-percent profit, but I will check it. I remember that their original investment was relatively small, and they got much more than their original investment out of it, several times more.

Senator HUGHES. What did the stockholders get?

Mr. SMITH. The two-thirds stock of the company holding the management contracts was sold to Tri-Continental Corporation and thereafter Tri-Continental Corporation supplied the management of the company at the operating level, although Maynard, Oakley & Lawrence and their group have since remained as a substantial majority of the board. Maynard, Oakley & Lawrence continued thereafter to get brokerage from the two companies that they had formerly managed. Tri-Continental Corporation in turn is managed by J. & W. Seligman, subject to an independent board.

Under the management of Tri-Continental Corporation each investment is in effect managed by J. & W. Seligman.

Just one further fact in regard to the importance of supervision at the operating level.

I notice that National Bond & Share, for 1 year—1934—paid brokerage commissions amounting to 2.86 percent of the average assets of the company. The usual management fee is one-half of 1 percent. I am not saying that that was not beneficial to the company. I think National Bond & Share has had a very good record; but I say that that illustrates the problem.

Mr. SCHENKER. Just one other point, Senator. There were the situations where people were associated with more than one investment trust, and there was a great deal of discussion to the effect that this legislation will affect them. They say, "We will have to give up one of our trusts," and so forth. The fact of the matter is, Senator, that this bill does not prevent anybody from having an association with more than one investment trust, even as manager in the broad sense.

I think a great deal of emphasis was placed here on "management," and I do not think there was sufficient indication that we drew a distinction between a "manager" and an "investment adviser."

A manager substantially is the person who not only gives investment advice but has really the power to take his own advice and execute the transactions. An investment adviser is an individual who gives investment advice to the board of directors. They can take it or leave it.

What we have said is that you can be the manager of one trust, and you can be an investment adviser of another or two others or three others. That distinction, we felt, was some protection against any conflicting interests. He can manage, he can take his own advice, and he can execute all transactions for one investment company. If he is associated in a similar capacity with another invest-

ment company he can give advice, but there must be some directors independent of him who can refuse to take the advice.

So there has been a great deal of discussion, as I said, with respect to managing more than one investment trust. The fact of the matter is that they can give investment advice to more than one investment trust.

Now, Senator, Mr. Cabot is in that situation. I think you heard him testify. He said this bill does not touch him except in one small instance. Mr. Cabot is the manager of State Street, and he is the investment adviser to the Shawmut Bank investment companies. This is really a codification of the practice that Mr. Cabot has been following, of acting as manager of one company and investment adviser to the others.

I would like to go on with reference to paragraph (b) on page 23.

In order to cover a situation like Tri-Continental Corporation, we have permitted interlocking directors if they are in the same investment-company system. If A company is controlled by B company which, in turn, controls C company, there can be interlocking directors in that situation.

Then we go on to say that where the relation involves a bank, you can have an interlocking majority. The big point was made, "If it is all right to have interlocking directors with a bank, why do you forbid it in the future? This provision permits the status quo interlocks, but in the future you cannot have that type of situation."

Well, I don't understand that argument. The study showed that interlocking relationship between investment companies and banks was a very unhealthy relationship, both from the point of view of the bank and from the point of view of the investment trust.

Senator HUGHES. Is not that a broad statement, that you can have interlocking directors of banks?

Mr. SCHENKER. There can be an interlocking director between the bank and the investment company.

Senator HUGHES. The statute applies to other banks. There cannot be a director of two banks.

Mr. SCHENKER. That was one of the things that persuaded us to feel that the same prohibition ought to apply to investment companies; but we did not recommend that you go that far. We do permit the interlocking of minority directors; but with respect to interlocking between a bank and an investment company we do not disturb the existing situation, although our study shows that it is not very satisfactory as far as the investment company or bank is concerned, to put it mildly.

However, because of the delicate relationship between banks and investment companies, we said we would not recommend that the status quo be disturbed; whereupon, after making that concession, the industry argues that if the status quo is all right, why should not new such relationships be permitted in the future?

That is the nature of the argument you heard here. I will not elaborate my answer.

Mr. SMITH. I think there is nothing so clear as the fact that this relationship between the banks and the investment companies has proved unfortunate. The president of the Liberty Bank said that there ought to be absolute segregation. The head of the M. & T. Bank said the same thing. The head of the Central Illinois said that

the relationship was unsatisfactory. I do not think there is any question about it as far as our record is concerned.

Mr. SCHENKER. The directors of the Chatham & Phoenix Bank, which also had an investment trust, said it was a very undesirable and unfortunate relationship.

However, there are one or two such situations which are still left, and we recommended that they be not disturbed, but that the relationship should not be permitted to be created in the future.

With respect to the relationship between investment counsel and investment trusts, you probably heard the testimony of Mr. White, of Scudder, Stevens & Clark, and Loomis-Sayles. Mr. White had specific provisions which he thought should be imposed; and I think they merit consideration. I do not think there is any useful purpose subserved in elaborating upon that particular peculiar situation.

Senator HUGHES. I did not hear Mr. Cabot's testimony.

Mr. SCHENKER. Mr. White said substantially that he had—

Senator HUGHES. I heard Mr. White.

Mr. SCHENKER. We now get down to subsection (c) on page 24 of the bill, and Mr. Smith wants to discuss that subsection.

Mr. SMITH. Subsection (c) and subsection (e) (2) and subsection (f) are all closely related. They all apply to the investment bank relationship to investment companies.

Usually the investment banker is also a broker, so that you have not only the problems that arise from brokerage—I should not say that every investment banker is usually a broker, but a great many of them are—you have the problems that arise from brokerage and also the problems that arise from the underwriting business.

In subsection (c) we provide that an investment banker or broker shall not serve on more than one investment company. In other words, one investment company is enough for an investment banker or broker.

That ties in with subsection (f) which says that an investment banker cannot do underwriting if the investment company owns more than one-half of 1 percent of any class of securities outstanding of a portfolio company.

In other words, if an investment banker is on an investment company and the investment company owns more than one-half of 1 percent of an industrial company, he cannot get the underwriting business.

It is quite obvious that if you have investment bankers on a number of investment companies, aside from other reasons, that provision would be evaded because he would very quickly build up a large percentage of control through a series of investment companies; and our experience has been that investment bankers do not confine themselves to one investment company, but they have gotten into whole series of them.

I think you will find that Lehman Bros. have been connected with five or six. That is covered in chapter I, part 3.

If you are going to have any restriction upon underwriting—and Mr. Bunker agreed that some restriction might be wise, and suggested 5 percent—we suggest one-half of 1 percent. It seems to me that you have also got to take into consideration some restrictions upon the number of investment companies that the investment banker can be on, because there is a tendency for investment bankers to put the securities in which they are interested into their portfolios.

Some people have said that an investment trust that is sponsored by an investment banking firm is no better than the clients of the investment banker. That sort of investment may be done in good faith, because they think they know about it, but the fact remains that they do do it, and where they are connected with more than one trust you find the same issues.

We have given you a list of cases of companies whose managements are open to some suspicion. On the other hand, I would like to point out the situation as it exists in a good type of company, the Lehman Corporation, as of December 31, 1930.

I point this out: Four of Lehman Bros. are directors of General American Corporation, another investment company, Mr. McGrath's investment company. You will find that 62 of the total of 193 issues in Lehman Corporation's portfolio were also in the portfolio of General American Investors Co., which had 102 issues in all. In other words, 32 percent of Lehman's issues overlapped General American Investors, and 60 percent of General American Investors' issues overlapped with Lehman Corporation.

Senator HUGHES. A man might think well of some particular issue. If you had made a careful study of some security and came to the conclusion that it was a first class thing to invest in, and somebody comes along and asks your advice about it, you would naturally think well of it.

Mr. SMITH. That is correct. That ties up with the issues that they underwrite. I can give you another example of that same sort of an interlock—Hayden-Stone and Hallgarten, in 1929. Hayden-Stone were the sponsors of Adams Express, and there was a general sponsorship of Hayden-Stone and Hallgarten of two investment trusts, and there was a 40 or 50 percent overlap there. The significance of it is that that overlap very often consists of securities in which investment bankers are also interested from the point of view of underwriting. That complicates the problem.

As you say, it is obvious that if a man is on both boards he may recommend the same securities. But you may also get the increased impact of the underwriting problem—the relationship of the investment banker using the investment trust to help him with his underwriting business when his issues appear in more than one trust.

Taking Lehman Bros., since 1936—and they disclose this in their reports—they have acted as underwriters for at least 51 security issues for companies whose securities were in the portfolio of Lehman Corporation.

I can go down through the list of those corporations. They are big ones, and many of them they would have gotten anyway; but there is no question that it helps to have an investment company have a big block of stock or bonds in the company from which you want to get underwriting business. The underwriter has various interests in having his investment company hold blocks of stock. First, it can be a "bird dog"—a means of getting business. If the investment company sponsored by an investment banker buys into an industrial company he can use his position as a means of getting either on the board of, if he has got the underwriting business, he can put a block of the stock of the industrial corporation into the investment company in order to keep the business.

He is also interested in keeping his capital free, because a typical underwriter, as I pointed out earlier, keeps turning over his capital

very quickly and he cannot afford to have his money tied up in securities that have become a little slow. It has been shown that as to 17 out of 57 issues in which an investment company had 1 percent holdings, the investment banking sponsor got underwriting business. That ratio is higher than the amount of underwriting business they got from their smaller holdings; so the higher the holding the more chance there is of getting underwriting business.

In my reference to Lehman Corporation I have not tried to insinuate that there is any activity on their part in bad faith. I am merely trying to take a company whose management I think is trying to do an honest job, but still to show that the tendency is to have a close relationship between the banking business and the investment-company business.

Mr. SCHENKER. Just one thing more, Senator. I am sure that you would like the record to indicate that the fact that specific names were mentioned does not remotely mean that we are making any accusation that there was anything improper or wrong or reprehensible done. The only thing that Mr. Smith and myself were trying to indicate—at least, as far as I am concerned, and I am sure that it is true of Mr. Smith—was that there are certain problems by virtue of this relationship; and the fact that a name is used is no indication that that company is being singled out or has any standing other than any other company. Possibly the cases should have been given as suppositious situations. We are particularly anxious to have the record unequivocally show that the fact that names are mentioned carries no significance so far as the companies are concerned. We are just discussing the problems that are presented.

Mr. SMITH. I agree with Mr. Schenker's statement in that regard, Senator.

Senator HUGHES. You are not picking them out for condemnation because they are in that line of business. They illustrate a line of business.

Mr. SMITH. That is right.

Senator HUGHES. Were you going to say something, Judge Healy?

Mr. HEALY. The situation down at my office is such that I am needed to make a quorum.

Senator HUGHES. Suppose we take a recess until 10:30 tomorrow morning.

Mr. HEALY. Is there any chance to get going at 10 o'clock.

Senator HUGHES. So far as I am concerned. I think I could, but I do not know what the chairman may think about it. I can stay half an hour longer at this time.

Mr. SCHENKER. Then we can finish with section 10.

You will see on page 25 of the bill, Senator, we deliberately inserted a provision permitting persons, who may not act as managers, to act as investment advisers. Although the definition of an investment adviser would have indicated that a distinction was being made between a manager and an investment adviser, we deliberately put into the section, starting on line 8, page 25, the statement that a person can act as an investment adviser for more than one company; or if he is a distributor he can act as investment adviser.

I would like to discuss briefly section (e) on page 25. This question of interlocking directors between an investment company and a portfolio corporation is not an easy problem. Judge Healy and I indicated on our affirmative presentation that we felt there were

problems created when an investment company which is supposed to be an investor in the corporation becomes tied up with the management of the corporation in the form of a directorship. What this section says is that the diversified investment companies should not have any interlocking directors with companies in which they are interested.

Then you heard the analysis that by virtue of this provision we have immediately eliminated from participation in directorships of investment companies about 15,000 people who are the best brains in the country and who have the requisite business training for directorships, and so forth. I think it was Mr. Bunker who said there were 1,100 issues on the New York Stock Exchange. If you average about 15 on the board, there would be about 15,000 persons.

I know that Mr. Bunker will not misunderstand me when I say this, but the first thing I did when I went back after the hearing was to take a look at the board of directors of Lehman Corporation to see how many of these 15,000 people were on the board of directors of Lehman Corporation or how many of them had ever been on Lehman Corporation's board. I found, Senator, that not a single one of those 15,000 had ever been on the board of directors of Lehman Corporation except the partners of Lehman Bros. That is, these partners were directors in industrial corporations, but the only directors of industrial corporations who were on the board of Lehman Corporation were the partners of Lehman Bros. I may be wrong about that, but I found that throughout the entire history of the Lehman Corporation the only directors of industrial corporations and other corporations on the board of Lehman Corporation were the partners of Lehman Bros.

Senator HUGHES. Do you infer that that is typical of others also?

Mr. SCHENKER. I think that is true of General American Investors Corporation, Mr. McGrath's company. I think the situation is that they have some directors of industrial corporations; but as I took a look at it—and if I am wrong I will let Mr. McGrath correct me—the investment trust did not have a single share of these companies in their portfolio; so those directors would not be disqualified under this section.

The question is, Senator, which is the chicken and which is the egg? Is the objection that we are keeping directors of industrial corporations off investment companies, or is the objection that the directors of investment companies cannot get on the boards of portfolio corporations?

There is a big difference, as far as the effect on the present situation is concerned. I mean, if you take the history of those companies—I think this is probably substantially correct—those companies would not have been very substantially affected by this subsection except in the sense that the directors of the managing company might not have been able to be on the portfolio corporation. I am not denying that it is quite an important problem for investment bankers. They are on the boards of a great many corporations. Yet that is the situation.

We tried to indicate what the problem was, and I think it has been as well stated by Paul Cabot as anybody else. Mr. Cabot was a little critical of Judge Healy because Judge Healy did not read his whole article. He read a portion of it, and Mr. Cabot said, "You didn't read the whole article." I will read another little portion, and it still won't be the whole article.