part of the contributors to these funds received no voice in the direction of the management of the company, and that, on the other hand, sponsors and promoters who invested a very minor part of the total contribution placed themselves in the exclusive position to determine the policies and activities of the companies. As a result of the study the Commission concluded that this unbalanced allocation of voting privileges—the fact that a substantial proportion of security holders were disfranchised of any voice and the fact that, for a minor contribution, a certain class of security holders constituted themselves the arbiters of the company—was largely responsible for many of the abuses and defects which developed in the course of the histories of the companies. Such practices as "dumping" and "unloading," hazardous investment projects, consolidations and mergers, dividend and repurchase policies, market operations in the securities of the investment companies—activities frequently very prejudicial to the interests of the classes of security holders which were not given representation—would very largely have been minimized had more representative and democratic voting privileges been extended to the outstanding security holders of the companies.[10]

Since existing capital structures, which were formed on such a pattern, are not disturbed by the proposed bill, it was deemed advisable to lodge in the Commission, after a lapse of 2 years from the effective date of the proposed bill, the power to intervene on behalf of the public investor in such cases where the existing distribution of voting privileges had come to be patently inequitable and constituted a real menace to certain classes of security holders. The bill does not provide for any alteration in the rights of security holders to assets and dividends, nor for the disturbance of any priorities, nor for the modification of the proportions of profits or earnings payable to the holders of the different classes of securities, nor for any additional safeguards for the holders of any of the classes of securities, nor for the diminution of any other advantages which sponsors and promoters may have elicited through the variation in rights and privileges of classes of security holders. The bill, however, would allow the Commission to direct a company in which there is a demonstrably inequitable disfranchisement of outstanding security holders to make a readjustment of voting privileges which would give the disfranchised classes some representation.

Several sponsors of investment companies expressed dissatisfaction with this provisions of the proposed bill. Raymond D. McGrath, executive vice president of General American Investors Co., Inc., said: "We would be forced to accept, pursuant to section 18 (d), whatever restriction of our voting rights the Securities and Exchange Commission might deem to be equitable." In speaking of the possible effect of section 18 (d) as "a restriction of our voting rights" rather than as an extension of some voting privileges to other classes of security holders, Mr. McGrath is not, apparently, viewing the problem from the standpoint of the security holders as a whole, but is obviously identifying himself with sponsors who, by an original disproportionate allocation of voting rights, secured control of investment companies, and may now be reluctant to be subjected to the possibility of any restriction or diminution of their voting preeminence. The contention is made that section 18 (d) may bring about the receipt by certain classes of security holders of a voice in the management not granted them in the original contract, to wit: That voting privileges were not "nominated in the bond" when the sponsors sold certain classes of security holders their securities. It is significant, however, that at the time they testified before the Commission many sponsors acknowledged the existing inequities in the distribution of voting privileges and conceded that a more equitable distribution was extremely desirable for the industry at large.

Christie P. Hamilton, of Illuminating & Power Securities Corporation, testified at the public examination before the Commission:

"A. Well, I think the ideal position would be that the investments should have votes according to the actual cash invested, largely.

"I don't know how it could be worked out underneath the corporation laws of the various States so that that could be brought about, but in my experience I think we have a situation where stockholders have investments, and certain rights have been taken away from them. They have created privileged stocks which have the characteristic of a bond without any vote and then they create a large

[10] Part Three, Chapter V of the Report contains many examples of the immediate and prospective control of investment companies secured by sponsors with a disproportionately small investment. Chapter V also shows how widespread in the investment company field have been the many advantages to the sponsors and disadvantages to the public investors resulting therefrom.

amount of common stock which will outvote the preferred stock, and therefore a very small investment may have the result of controlling a great deal of capital that is ahead of it. And if everybody is as wise as God, it would be a fine situation to have that control; but we are not.

"Q. I take it you would be against nonvoting preferred?

"A. I think that the man who puts his money in this corporation has a right to vote as he sees fit, and if the management is deemed unfit, that vote should have the power of removing that management. Is that clear?"

Leland R. Robinson of the Founders Group declared in his prepared statement:

"XII. Encouragement should be given to that type of investment company set-up involving a wide public distribution of one type of capital stock, each share possessing a vote; while voting privileges should also be accorded to preferred stock in such a way as to minimize the opportunities to swing control of large amounts of capital through possession of dominating blocks of common stock.

"V. An end should be put to any special types of promotional or control stock, at least in connection with investment companies offering their securities to the public as investment trusts. The capital structure should be simple and clearly defined."

Floyd B. Odlum, of Atlas Corporation, declared in his prepared statement:

"I also think that directors should represent all stockholders and not any class or group and, consequently, that so-called minorities should not be left either in theory or practice without representation."

Morton H. Fry, of Reliance International Corporation, testified:

"Q. But you state in that letter, 'It has always seemed to me to be somewhat questionable to have the stock which has paid in such a small amount of money to have such a disproportionate voting power.'—A. I think that was rather a loose use of the word 'always.' It may be due to the fact that 1930, 1931, and 1932 seemed interminable. I don't know.

"Q. What is your present view on that? Do you agree with Professor Ripley of Hardvard, that the people who put up the money should have the voting control?—A. I most certainly do. I most certainly agree that the people who put the money should have voting control."

It might be pointed out at this time that section 18 (d) does not require, even in the proven cases of inequities to which the section might be applied, that senior securities receive voting privileges in the proportion in which they contributed to capital, as some members of the industry recommended. Nor does it require that classes of securities receive voting privileges in the ratio of their current interest in the assets of the company. Under the section, the company can be required to take steps only when the particular condition of the individual company—such as interest or dividend arrearages upon or impairment of principal of senior securities added to the concentration of control in the hands of particular classes of security holders—makes the existing distribution inequitable; and the company can be directed only to effect such a redistribution as will be "equitable" in the light of the special circumstances. There is nothing in the proposed act compelling an *equalization* of voting privileges.

The most patent application of the Section would probably be found to be in cases of classified common stocks, i. e., where a security has been labeled as a common stock and has been deprived of any voting power, whereas another type of common stock, though having no asset value, is entitled to all or the major part of the voting power.

Earle Bailie, president of Tri-Continental Corporation (Mr. Quinn, the executive vice president of that company testified at length before the committee), testified as follows at the public examination:

"A. That would be an example of what I was talking about. It seems to me anybody who has equity money in it, or in the ordinary course of events there should be one class of common stock, and it should have the same par value and the same voting rights, no matter whom it is owned by. I do not think it is effective or useful to have different classes of common stock. There may be some special cases where that works a hardship, but in general I think the rule should be 'one share, one vote.'"

A special study was made of the relation between voting power and asset value of the "special management stocks" or "class B stocks" at the end of 1939. Of the 11 closed-end companies having a class A and class B stock, the class B stock had no asset value in the case of 5 companies and a very insignificant asset value in the case of 4 other companies. In all but one of the 11 companies the "management stock" holds effective voting control, the one exception being American

Capital Corporation, where the preferred stock has succeeded to exclusive voting power because of arrearages in its dividends; and that company is controlled by Pacific Southern Investors, Inc., which itself is controlled by the voting power of a "class B" stock which has no asset value.

Of the three open-end companies which had classified common stocks, two are controlled by the "managers' shares" which are entitled to only a very small proportion of the assets, while in the case of the third company the "managers' shares" were converted into "investors' shares" on October 11, 1931.

Exhibit E annexed shows in tabular form the comparative rights in distribution and voting privileges of these companies.[11]

An examination of the data on 16 large management investment companies discloses in each case the striking disproportion between the relative equity of various classes of securities in the net assets of the company and the distribution of voting power. (See exhibit F, annexed.) In the case of two companies where the senior securities are "under water" and in arrears with respect to dividends—and, of course, entitled to all the assets of the company—the senior securities have no voting rights at all.[12] In other companies where the senior securities are "under water" and in arrears, the senior security holders who have one vote per share still have no effective voice in the management because of the larger number of common shares outstanding.[13] In the other cases, the senior securities had either no, or a very slight, voting power, although they were entitled on involuntary liquidation at the end of 1939 to all or a great part of the assets of the company.[14]

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[11] The following is a summary of the present status of the voting power in these companies:

CLOSED-END COMPANIES

Capital Administration Company, Ltd.: Preferred, class A, class B: Although class B has no asset value (and class A is under water) class B has the right to elect two-thirds of the board.

Bankers National Investing Corporation: Class A and class B: The class B stock is entitled to 1.98 percent of the assets; has the right to elect a majority of the board.

American Insuranstocks Corporation (December 1937): Preferred, class A, class B: The preferred votes because of arrearages, nevertheless the class B stock having no asset value has 62.6 percent of the voting power.

American Capital Corporation: Prior preferred, preferred, class A, class B: The preferred has exclusive voting power due to arrearages, but 27.9 percent of the outstanding preferred is held by Pacific Southern Investors, Inc., which is itself controlled by an assetless B stock.

Pacific Southern Investors, Inc.: Debentures, preferred, class A, class B: The class B stock which will have no asset value until the company's assets almost double has 76.6 percent of the voting power. This controls American Capital Corporation above.

Italian Superpower Corporation: Debentures, preferred stock, class A, class B: The class B stock although it has an asset value of only $500,000 out of $30,800,000 of assets has exclusive voting power.

Railway and Utilities Investing Corporation: $3 and $3.50 convertible preferred stock, class A, and class B: The class B with no asset value has the right to elect the majority of the board.

Federal United Corporation: Preferred, class A, and class B: The class B which has no asset value has 70.6 percent of the voting power.

The Reserve Investing Corporation (December 1937): Preferred, class A and class B: The class A, which are the management shares, have exclusive voting power although entitled to less than 1 percent of the net assets.

Fairfield Securities Corporation: Preferred stock, class A, and class B: The class B stock, entitled to 30 percent of the assets has the exclusie voting power.

Railway & Light Securities Co.: Preferred stock, voting common stock, and nonvoting common stock; preferred stock has a regular vote per share; only a fractional part of the common stock is disfranchised.

First Investment Counsel Corporation and Third Investment Counsel Corporation give a vote only to the 30 class B shares outstanding in the case of each company. These shares are entitled to only an insignificant proportion of the assets.

Investors Fund C on October 11, 1931, converted the 700 managers' shares into the same number of investors' shares.

[12] General Public Service Corporation: Italian Superpower Corporation.

[13] American Superpower Corporation; Central-Illinois Securities Corporation; Central States Electric Corporation; Commonwealth Securities, Inc.; Selected Industries, Inc.; Standard Investing Corporation; United States & International Securities Corporation; and Western Reserve Investing Corporation.

[14] In United States & Foreign Securities Corporation, the 2 classes of preferred are entitled on liquidation to 78 percent of the net assets. The second preferred is $49 a share in arrears with respect to dividends. Neither of these classes had voting rights at the end of 1939. In the case of General Shareholdings Corporation, the preferred is $8 a share in arrears and is entitled in involuntary liquidation to 84 percent of the total net assets, yet the preferred-stock holders may exercise only 5 percent of the voting rights. The senior security holders in the Equity Corporation are entitled in liquidation to all the net assets, yet the common has 95 percent of the total voting control. In Tri-Continental Corporation, the senior security holders have a 70-percent equity in the net assets, but only 6 percent of the votes. In General American Investors Co., Inc., the debenture and preferred holders together are entitled on liquidation to 46 percent of the net assets; the preferred has 5 percent of the total voting shares.

It should be noted that these unbalanced distributions of voting privileges stem from the patterns of capital structure devised by sponsors and promoters at the inception of the companies.[15]

Paul C. Cabot of State Street Investment Corporation expressed concern that a possible effort in the way of equitable redistribution of voting privileges in specific cases might force "the breaking of many legitimate contracts that have been entered into in good faith by the contracting parties." Eleven years ago, when investment companies were being formed en masse, Mr. Cabot was apparently less impressed with the "good faith" of sponsors who organized investment companies with the public given little voice in the direction of the management of the companies. Mr. Cabot, in an article in the Atlantic Monthly, which has been previously cited at these hearings, wrote as follows:

"Some months ago, in testifying before a committee of the New York Stock Exchange, I was asked to state briefly what were, in my opinion, the present abuses in the investment-trust movement. My reply was: (1) dishonesty; (2) inattention and inability; (3) greed.

"It is of the last of these that I now wish to speak. You may be asked to subscribe to a trust that is both honestly and ably run, and yet find it inadvisable to do so simply because there is nothing in it for you. All the profits go to the promoters and managers."

"There are an infinite number of ways whereby this unduly large slice of the spoils is kept by insiders. They may own all or a very large percentage of the equity stock; they may have warrants and options; or, more rarely, they may be able to take out the money in the form of expenses or managerial fees of one sort or another. * * * *The most common method of accomplishing this result on the part of promoters is an exceedingly complicated capital structure.* There are many investment trust prospectuses in which it takes literally hours to figure just how profits are to be divided. To those not trained in finance

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[15] The discussion by Arthur Stone Dewing (Financial Policy of Corporations) is of interest in this connection:

"*Pseudo-Preferred Stocks.*—This in brief was the original intent of preferred stock, but during the last quarter century, especially in the financing of industrial and public utility enterprises, preferred stocks have been used for the purpose of enlisting capital from the public on what appear to be liberal terms, in such a manner that the control of the enterprise is held by an issue of common stock which stands for no investment. Preferred stock, issued under such conditions, is merely common stock with all the attendant risks and none of the advantages, since the holders of the so-called common stock have entire control, with no actual investment in the enterprise. The simplest case of this character is represented by a financial plan in which the tangible assets are exactly represented by preferred stock and the common stock is issued for control purposes only." (Pp. 47–48.)

* * * * * * *

"* * * The managers, who may own only the common stock, become intoxicated with their success in a small way, and falsely assume that still greater success will follow the expansion of the business. They, being owners of the common stock, have everything to gain and nothing to lose; the preferred-stock holders, being limited in the amount of their dividends, have everything to lose through the failure of the expansion and nothing to gain through its success. It is for their advantage that the business should be small, compact, and able to resist depression and possible tightness of the money market; a big business adds nothing to their security, but it does jeopardize the maintenance of their dividends." (P. 58.)

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"Above all else it is essential that nothing in the preferred stock contract may be interpreted as giving the stockholders an actual lien on the corporate assets ahead of the notes and current obligations which it is proposed to negotiate in the future. All the other provisions of the preferred stock issue are innocuous 'safeguards' which help the sale of the stock among investors, without embarrassing the contemplated policy of corporate expansion on the one hand or giving real security to the stock on the other. Even the compulsory redemption of preferred stock referred to later, when adroitly worded by a corporation's counsel, can be interpreted as an intention rather than as an enforcible provision. They are the showy trappings of the advertising manager—mere trimmings." (Pp. 60–61.)

"One may hazard the supposition that the typical financial structure of the immediate future will be much simpler in form. The further extension of the intermediate securities—securities which attempt to combine the investment stability of bonds and the income increase possibilities of common stocks—is probably closed. Investors wish to know exactly the kind of thing they buy. They have come to realize, for a few years at least, that they cannot buy two things for the price of one. They cannot get both security and the opportunity for increase of income for the cost of security alone. If this is true, corporations, unable to find a market for the intermediate securities, will probably insist on a simpler financial structure. The characteristics, both the privileges and the limitations, of their bonds and their stocks will be more clearly defined. It is quite possible that common stock and common stock alone will again be found in the financial structures of all types of corporations; and it is quite possible that the bondholder will be given certain rights in the management of the corporation, such as the right to elect one or more directors or the right to exercise a controlling influence on the major plans of expansion. If that is done, the legal implications of the fundamental distinction between creditor and owner will be still further obliterated." (P. 67.)

the task becomes impossible, and the promoters have accomplished their purpose. Certainly a clear statement of how the money is supplied, and the profits divided, together with a simple, straightforward capital structure, is highly desirable.

"*Another danger, usually the result of greed, takes the form of a very large funded or floating debt or an excessive issue of preferred stocks.* Very often the managers and promoters receive their compensation and profit in the form of common stock for which they have paid little or nothing. There is nothing to criticize in this procedure if it is clearly and simply stated so that all can easily understand. As is pointed out in such cases, the management receives nothing until it has earned and paid some fixed percentage on the senior securities. In other words, the compensation is dependent upon the success of the enterprise. *But the difficulty is that the management or promoters have put up only a small percentage of the total funds. If the enterprise is a complete failure, they have little or nothing to lose.* It is natural, therefore, that they should take the attitude of 'Let's either win big or nothing.' This they accomplish by a very heavy pyramiding process. I do not believe that there are many people who with only $100 equity would, as a general practice, proceed to borrow and buy anywhere from $800 to $1,000 worth of securities, and yet that is exactly what many investment trusts are doing today.

"There is another difficulty to which pyramiding leads. With very heavy fixed charges and preferred dividends to meet, the management is under the constant necessity of producing a large dollar income the first and every succeeding year of operation with which to meet the relatively large fixed charges. This pressing necessity to produce immediate and constant income forces the investment of a large proportion of funds in securities of a less desirable type." [Italics supplied.]

It is true that in that article Mr. Cabot warns against "over-regulation" and states: "All that legislation should do is to require a degree of publicity that will enable any investor to form a sound opinion." The study compels the Commission to differ with Mr. Cabot on the effectiveness of mere publicity. In the first place, publicity will not help the investors whose contribution has already been secured for the types of capital structures so strongly condemned by Mr. Cabot. Secondly, the exposition by Mr. Cabot of the lack of sensitivity of the average public investor to the niceties of capital structure and the subtleties of the rights and privileges of security holders would appear to show clearly the ineffectiveness of mere publicity. To quote Mr. Cabot again from the same article:

"There are many investment-trust prospectuses in which it takes literally hours to figure just how profits are to be divided. To those not trained in finance the task becomes impossible, and the promoters have accomplished their purpose."

Paul C. Cabot in his testimony commenting on section 18 (d) of the investment-company bill cites the hypothetical example of a company formed with $5,000,000 of preferred stock and $5,000,000 of common stock which has paid preferred dividends regularly, but has had its assets reduced to $7,500,000. The preferred stock is fully covered but the equity of the common stock has been reduced to $2,500,000. The preferred stock is selling at a market discount, to wit, $80 per share.

At this point Mr. Cabot enters upon a number of suppositions, to wit:

1. The Commission will exercise its discretionary power of redistributing voting privileges.

2. The Commission will grant the preferred stock two-thirds of the entire voting power, and reduce the voting power of the common stock to one-third of the whole.

3. That the preferred stock, having received two-thirds of the voting power, will proceed to liquidate the company in order to realize its full $100 asset value which is $20 per share more than the current market value.

The result of these steps, Mr. Cabot argues, will be that the common stock will be compelled to take its asset value; and the loss sustained by that stock will be frozen against it with no chance of a come-back.

Mr. Cabot assumes for his suppositious case that the preferred stock has been originally granted a right of vote in the event of a default in dividend payments. It should be noted that only in rare instances has the preferred stock been given an effective voice in the management of the company even after default. Out of the 89 management-investment companies (of 160 companies examined) which had preferred stocks, only 4 companies provided that voting

control should pass to the preferred stock upon a certain period of delinquency in dividends. Twenty-six of the companies failed to grant any voting rights to the preferred on the passing of dividends. While the other 33 companies granted the preferred stock a right to vote on this contingency, the voting right granted was on the basis of a vote per share. Since the number of shares of common stock usually far outnumber the preferred shares, the voting rights granted the preferred stock were generally of small effect.

In Mr. Cabot's example, the shares probably would have been sold as follows: 50,000 shares of preferred stock at $100 a share for the $5,000,000 from senior security holders and 500,000 shares of common stock at $10 a share for $5,000,000 from the junior security holders. Although both classes of stock have made an equal capital contribution to the company, the common stock has 10 times as many votes as the preferred stock, even if the preferred stock has been granted a regular and permanent vote per share. Arguably the common stock is entitled to this voting supremacy because it has supplied a "cushion" of $5,000,000 to protect the preferred stock. However, it is equally arguable that when this "cushion" has vanished or substantially decreased, the reason for excessive voting power in the common stock also disappears. This argument is further supported by the fact that the common stock originally entrenched itself in the management of the company, and the disappearance of the cushion is thus attributable not to any activities of the preferred stockholders but primarily to the management by the common-stock holders. In such case an equitable redistribution of voting power may be needed to protect the preferred-stock holder. Section 18(d) of the proposed plan empowers the Commission to make this equitable distribution of voting power. What is equitable depends on the facts and circumstances of the particular case. This does not mean that the Commission may act arbitrarily. Its determination will be made only after a hearing in which all sides may be represented. Furthermore, an appeal to the courts from the Commission's decision is available.

Mr. Cabot arbitrarily assumes that the Commission would move in the particular instance for a redistribution and undertakes to decide in advance of a Commission decision what would constitute an equitable distribution of the voting power, namely a two-thirds voting power in the preferred-stock holders which will enable them to dissolve the company to the detriment of the common stock. Even so fundamental a type of redistribution as the allotment of voting power in accordance with the capital contributions made to the company by the various classes of shares, would mean that the preferred stock would acquire only fifty percent of the voting power—a quantum of votes equal to that of the common stock and insufficient to dissolve the company without the consent of the common-stock holders, since most State laws require a vote of the holders of two-thirds of the voting shares to effect a dissolution. Even such voting power might be allocated to the preferred stocks only until the asset value of the common stock had increased to its original value $5,000,000—or to such a sum as the Commission might determine to be fair to the preferred-stock holders. An alternative method might be to give the preferred-stock holders power to elect a minority or a majority of the board of directors until an adequate cushion of common-stock assets appeared. There is no basis whatsoever for assuming that power would be given the preferred stock to compel a dissolution of the company.

PRESERVATION OF CUSHION FOR SENIOR SECURITIES—SECTION 19 (B)

James H. Orr, president of the Railway and Light Securities Co., objects to the provisions of 19 (b) of the proposed bill. The study disclosed that it was a fairly common practice among investment companies to reduce the cushion upon which the senior security holders depended to a very slim margin by the payment of dividends to junior security holders. Subsequent losses could readily sweep away the narrow remaining margin and subject the senior securities to impairment of principal. In some instances dividends were paid out of contributed capital—the nominal, or official, capital having been reduced by a restatement of capital. In other instances payments of dividends on junior securities were made out of profits on portfolio security transactions (capital gains) in a period of rising market prices, with the result of injury to the senior securities with the advent of a period of less favorable market conditions.

The preservation of an adequate cushion is, of course, an indispensable condition for any sound bond investment.[16] The distribution of dividends to common stock or to a preferred stock which impairs the cushion of safety for the bonded indebtedness may be a real injury to the bondholders. A considerable number of indentures purport to accord a measure of protection of this nature by including a "touch-off" clause which requires the retention by the company of a certain margin of assets above the indebtedness.

Part Three, Chapter V of the Report shows that the cushion, which is thought to be preserved by the "touch-off" clause, is generally much too narrow and that these clauses are usually deficient by reason of ambiguity or unenforceability. Occasionally some investment companies have voluntarily incorporated in their charters provisions specifically prohibiting dividends or other distributions to stockholders unless some fixed margin for senior security holders will exist after the distribution.

For example: Tri-Continental Corporation provided that no divideuds should be declared upon the common stock unless at that time the net assets of the company equalled at least 200 percent of the aggregate amount to which all shares of the preferred stock were entitled in liquidation; American International Corporation provided that there should be no distribution upon the common stock if immediately thereafter the assets of the company amounted to less than 200 percent of all its funded debt. Such voluntary provisions are, of course, akin to the provisions of section 19 (b) of the proposed act.

Mr. Orr's objection to the provision of section 19 (b) appears to be based upon the fact that his company has paid preferred dividends regularly and dividends on the common stock since 1910, with the exception of 3 years; but that, in 28 out of the last 34 years, the asset coverage of the bonds has been between 200 and 300 percent; that is, within the area in which the S. E. C. is given discretion.

Mr. Orr appears to assume that at each prospective payment of a dividend to the preferred stock, when the coverage for the bonded indebtedness is between 200 and 300 percent, he would have to secure the consent of the Commission. It should be noted that the Commission may proceed by general rule and regulation—i. e., it may lower the required coverage to 200 or 250 percent for general application for a fixed period or until another rule or regulation is promulgated; or, for good cause shown, it may lower the coverage for a specific category of companies whose assets, policies, or voluntary protective safeguards are such that danger to the senior securities is not to be feared.

The witness does not deny that the cushion of safety for senior security holders should be protected. The Commission concedes that any absolutely inflexible margin would, by its very nature, be an arbitrary determination. That is the reason why it was thought necessary to allow for very wide flexibility in this connection. That the zones suggested in the proposed bill are not unreasonable is indicated by the fact that, in the great vicissitudes which the asset coverage of the bonds displayed in this company, the Act would disqualify the payment of dividends only in 1932 and 1933 and for the first quarter of 1938.

RESTRICTIONS AGAINST LONG-TERM BORROWING, SECTION (21C)

Objection has been raised to section 21 (c) which provides in part that after July 1, 1945, an investment company will be unable to renew or extend bonds or debentures maturing after that date.

The "introduction of leverage" by long-term borrowings was one of the practices of investment companies most severely criticized by investment-company sponsors and managers themselves at the public hearings.

Ernest B. Warriner, The Equity Corporation, testified:

"I would like to repeat also again, because I know that you are making these recommendations to Congress, that I do believe that all of my experience

[16] "Maintenance of adequate junior capital: We wish to call attention finally to a protective requirement for both bondholders and preferred stockholders which is technically of great importance, but which frequently is not taken care of in indentures or charter provisions. The point referred to is the maintenance of an adequate amount of junior capital. We have previously emphasized the principle that such junior capital is an indispensable condition for any sound fixed-value investment. No loan could prudently be made to a business at 5 or 6 percent interest unless the business were worth a considerable amount over and above the amount borrowed. This is elementary and well understood" (Graham and Dodd, Security Analysis, p. 224).

is that one of the greatest evils or dangers is the borrowing of bank money, which I have in my time that I was on the Boards endeavored to prevent, and that was borrowing of bank money for leverage purposes."

Frederick T. Hepburn, of the same corporation, stated that he was opposed to debentures because he thought that they did not fit into an investment company.

* * * * * * *

"Q. You think there was no debt mentioned——A. No; no debentures. You mentioned debentures. I would have opposed that. I don't believe it was mentioned——

"Q. I don't understand you.—A. I don't think there were any debentures mentioned, because I am sure I would have opposed it.

"Q. Why? Why would you have opposed it.—A. Well, I would have thought it was a definite obligation that did not fit this sort of operation."

Ralph W. Simonds, also of The Equity Corporation, testified:

"Q. Based on your experience with Yosemite Holding Corporation, do you think that a trust should borrow money from banks?—A. No, I don't."

Gare Dominick, National Bond and Share Corporation, testified:

"Q. Do you feel, for example, an investment trust should borrow money?—A. Again I am speaking personally. I dislike—I would dislike to manage a trust that is in the habit of borrowing money. * * *

"Q. Why would you in the future want to be certain to have cash in such transactions?—A. I don't think a trust of this kind needs to have the leverage of borrowed money. I don't believe they have to borrow money to make money, in most instances."

Lester Roth, National Securities Investment Co., testified:

"Q. The point I am discussing with you is, should they be permitted to borrow money?—A. I question it very much, as far as an investment trust is concerned.

* * * * * * *

"Q. Do you think under those circumstances that an investment trust ought to be permitted to trade on margin?—A. That is the same question you asked me, should they be permitted to borrow money, because it is immaterial whether they borrow from a broker or borrow from a bank. And I say that I doubt very much in the light of experience whether a trust should be permitted to borrow money."

Erwin Rankin, Founders Group, stated: "As far as borrowing from banks just to buy securities in the market, I don't think that should be done. That comes again on the question of leverage. I would rather see a company without any leverage."

Charles B. Stuart, Eastern Utilities Investing Corporation, testified: "I could only repeat what I said earlier in the day, that we just don't believe this type of company should ever put out a fixed interest-bearing obligation."

Harry M. Addinsell, of the same corporation, testified:

"And, of course, while we are on the subject, I have a very definite reservation in my mind as to whether things that are essentially, if you want to call this an investment-trust type, ought to borrow money from the public anyway. I don't believe I would want to handle such obligations now, because I think it is the sole, essential function of the management in the handling of an investment trust, and I think that the risk is more of a stock risk than it is a promise-to-pay risk, and I also think that it is almost impossible especially if you have a very large portfolio as distinguished from the theoretical idea of a call loan at a bank, to exercise your remedies, even though you have need to, because of the quantity involved and the fact that when you arrive at that kind of situation where you have to do something it is probably impossible as a practical matter to do it, in other words, to exercise it."

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"Q. Do you think the opinion of the investment bankers is substantially in agreement with yours that their influence will be sufficient to prevent the issuance of definite obligations by investment trusts?—A. I don't know the answer to that. I haven't discussed it with enough people to know what their point of view is."

Philip J. Roosevelt, of Investment Trust Funds A, B, and C, testified: "They should not borrow money, for if they do, they are in effect, operating a margin account for their investors which we believe means taking an unwarranted risk for their account. Stocks have sufficient volatility without any added leverage."

The sponsors of some of the largest investment companies testified to the extremely demoralizing effect of debenture capitalization and bank borrowings upon the policy and economic welfare of the companies.

Louis H. Seagrave, of the Founders Group, stated: "* * * there isn't a question in my mind but what excessive borrowing and excessive preferred stock are the virtual ruination that contributed more than any other factor to the difficulties of our group of companies. Therefore, I should say that if preferred stock or borrowing are to be permitted, there should be some restriction in the amount, either in the assets of the company, because that is done by the companies themselves, or by law. I think that is about the sum of it on that point."

Erwin Rankin, of the same group of investment companies, indicated why borrowings were so dangerous to investment companies: "For instance, when an investment company has a bond on which they have to pay 5 percent and pay 6 percent on the preferred, let us say the over-all is a 5 percent requirement on its capital, that company can't very well afford to be buying bonds that yield 3 to 4 percent.

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"It became clearly apparent in the type of decline that we had after 1929 that any single investment company couldn't exist with a large part of its capital in bonds and preferred stock just as a single company alone and when you have it as in the American Founders group with not only your subsidiaries, but with other companies on top of them, it became rather clearly apparent."

George D. Woods, Eastern Utilities Investing Corporation, testified:

"Q. What reasons do you have for your opinion that investing companies should not be in debt?—A. My conception of these investment companies is that they are primarily for the purpose of small investors who want to have the protection of some diversification as far as type of investment and location of investment is concerned, but do not have enough money to enable them to make investments in units which would bring about such diversification.

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"I fail to see why, having made such an investment for those purposes, there should be any prior obligations. My feeling is that these investment companies should gradually get into the category of the good fire insurance companies and casualty companies where if they have a preferred stock or if they have made a loan people immediately look askance at them, on the theory the good ones never have anything except common stock."

Under section 21 (c), outstanding bonds, debentures, or bank borrowings are not in any way affected. An existing obligation of this sort may be renewed or extended any time before July 1, 1945. All the existing obligations need not be liquidated until their maturity—whatever the date may be—and the companies have a period of 5 years within which to renew or extend these obligations to some future date, if necessary. The only limitation upon companies with existing indebtedness is that, if they do not choose before July 1, 1945, to renew or extend existing obligations, they will not be in a position after that date to embark upon a policy of renewed borrowings.

DEBENTURES IN AFFILIATED FUND, INC., AN OPEN-END COMPANY

John Sherman Myers, vice president of Affiliated Fund, Inc., and Andrew J. Lord, president of that company, objected to the prohibition of section 18 upon the issuance of additional debentures and the provision in section 19 (b) to the effect that no dividends may be paid to common stock unless outstanding debentures have an asset coverage of 300 percent. That section authorizes the Securities and Exchange Commission to raise the minimum coverage requirement to 400 percent or lower it to 200 percent.

Affiliated Fund, Inc., is an investment company of a somewhat unusual structure in that it is an open-end company—i. e., any stockholder may require at any time that he be given the approximate asset value of his shares on the surrender of the same; and yet has a senior security outstanding, to wit—two issues of debentures. Affiliated Fund, Inc., is the only open-end investment company of substantial size to have debenture capital in its structure. All other large open-end investment companies issue only common stock.

Mr. Lord explains very frankly the practical difficulties which the provisions to which he objects may put him. He states that the principal business of