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THE INVESTMENT COMPANY ACT OF 1940

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INTRODUCTION

An understanding of the Investment Company Act¹ of 1940 calls for a recognition of three important factors contributing to its composition: (1) the history of the investment company industry in this country with the general nature of the abuses to which it had been subject; (2) the pattern of recent federal legislation and particularly regulatory legislation whose enforcement has been entrusted to the Securities and Exchange Commission; and (3) the fact that federal legislation regulating investment companies would not have been passed by Congress in 1940 except for the active collaboration of the investment companies. In other words, the Act must be read in the light of the nature of the industry and the problems sought to be corrected, of the Administration's approach to such problems as evidenced by other legislation and of the fact that the Act constituted in a sense compromise legislation. It should be noted, however, that the Act was not an arbitrary or irrational compromise of irreconcilable differences, but was the result of an agreement reached by give and take on both sides, accomplishing on the one hand at least the main objectives of the original legis-

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The writer represented a group of closed-end investment companies at the Senate and House hearings on the investment company bill and participated actively in the negotiations leading to the agreement with respect to such legislation and in the drafting of the Act in its final form. Accordingly, although it is his intention that this article be as objective as possible, the writer recognizes that he is not a disinterested commentator.

1. (1940) 54 Stat.—; c. 686, tit. 1, 15 U. S. C. A. (Supp. 1940) sec. 80a, 11 U. S. C. A. (Supp. 1940) secs. 72(a), 107(f).

lation, and on the other hand meeting the chief objections to the bill as first introduced. This was made possible, not merely because of the real desire of both sides to cooperate, but more particularly because of the sympathetic understanding on each side of the opposing point of view. Both parties, the Securities and Exchange Commission and the industry, were apparently well satisfied with the result; and Congress seemed pleased to have presented to it without controversy so comprehensive a piece of legislation.

For a brief statement of the problems which the investment company legislation was designed, in part at least, to solve, reference is made to the Senate and House Committee Reports.² More detailed data will be found in the voluminous reports made by the Securities and Exchange Commission as the result of its outstandingly able and painstaking investigation of investment companies. These reports contain a mass of valuable material. They must nevertheless in some measure be regarded as in the nature of *ex parte* documents which have not been subjected to the test of controversy. Many statements appearing in these reports were disputed by representatives of the industry at the Senate Hearings³ and much of the material is subject to misinterpretation by the uninitiated. In general, it might perhaps be fair to compare the flavor of these reports to the flavor of the bill as originally introduced and the tone of the Senate and House Reports to the tone of the bill as finally enacted.⁴

Investment companies are often spoken of as the pooling of funds for the purchase of securities. While this is true, the unthinking use of these words has led many into the error of believing that significance attaches to the fact of the pooling of funds. This is not the case. Any corporation or joint enterprise is such. The difference between an investment company and other companies lies in the use to which these funds are put.

2. Sen. Rep. No. 1775 (1940) 76th Cong., 3rd Sess.; H. R. Rep. No. 2639 (1940) 76th Cong., 3rd Sess. Excellent summaries of the Act will be found in the reports, the Senate Report dealing with the subject functionally, and the House Report, section by section.

3. Much of the Government's testimony passed unchallenged because of the time factor and because in many cases those particularly concerned were not present or represented.

4. This is natural as the original bill was based on the Securities and Exchange Commission Reports, and the Senate and House Reports represented the point of view of the bill in its final form.

The significance of the distinction lies in the fact that the stockholder of a steel company does not have the choice of himself buying and working an anvil and forge or pooling his resources with others in the purchase and operation of a steel mill, while the investment company stockholder has the choice of himself purchasing securities directly or joining with others in the purchase of securities. By joining with others he may be able to diversify his risk to a greater extent than he could by himself, he may be able to afford more expert management, or he may be able to join in the purchase of control of one or more other corporations. But he is likely to be thinking of his stock always in terms of its pro rata share of the underlying securities and the income derived from them.⁵

In general, the types of investment companies which will be discussed in this article may be divided into open-end and closed-end companies and the latter into leverage and non-leverage companies.⁶ The provisions of the Act relating to unit trusts, face amount certificate companies, *et cetera* will not be discussed.⁷ Open-end companies are companies in which the stockholder has the right at any time to present his certificate of stock for redemption and to receive in exchange its approximate per share liquidating value, that is to say, the approximate value of its proportionate share of the assets. As there is normally a constant liquidation by stockholders who for one reason or another

5. Thus the stockholder is acutely aware of the investment costs chargeable to income and of the discount on the liquidating value of his security, which latter may in part result from these costs and in part from the lack of a ready market. Taxes, of course, are a substantial element in these costs. In fact, the tax burden is believed by many to be excessive. In this connection see Sen. Rep. No. 1775 (1940) 76th Cong., 3rd Sess., 12; H. R. Rep. No. 2639 (1940) 76th Cong., 3rd Sess., 10. Also, for a brief statement of some of the factors involved, see the writer's testimony on the Second Revenue Act of 1940 at the Joint Hearings before the Committee on Ways and Means, House of Representatives, and the Committee on Finance, United States Senate (1940) 76th Cong., 3rd Sess., 234.

6. Leverage companies are almost exclusively closed-end.

7. Unit trusts, mostly fixed or semi-fixed, although dating back as far as 1924, attained their rapid growth after the market decline of late 1929. They were to a large extent the forerunners of the open-end companies, although some of the latter were of earlier origin, and were in effect supplanted by the open-enders. They are now relatively few in number, and their securities are not being currently issued.

Face amount certificate companies constitute really a separate subject in themselves. They are companies which sell certificates on an installment payment basis, such certificates calling for payment of a fixed amount at a stated time.

desire to cash in on their shares, the open-end companies must engage in continuous selling of new shares of stock in order to replace the funds so withdrawn.⁸ In closed-end companies, on the other hand, as in the ordinary corporation, a stockholder has no such right, although it is not unusual for closed-end companies in their discretion to buy in their shares when selling at a discount below liquidating value. The leverage company is a company which has outstanding senior securities, whether in the form of bank borrowings, notes, or preferred stock. As these senior securities constitute a fixed first charge on the assets of the company, fluctuation in the underlying value of the common stock will be greater than the fluctuation of the value of the total assets of the investment company, depending in degree upon the ratio of the senior securities to the total assets of the company. For so long as there are assets sufficient to cover the sums to which the senior securities are entitled on liquidation, all gains and losses accrue to or come out of the common stock. Thus the senior security acts as a lever on the value of the junior security and so the structure or process is known as "leverage." This, of course, is just as true in the case of an industrial, railroad, or utility company, but in those enterprises the effect of the leverage, except in respect of earnings, is not so apparent since the assets of these companies have no quoted market value against which the relative interest of the common stock can be periodically checked.

By and large, the decade of the 1920's, and particularly the later years of this decade, was the period of the formation of closed-end investment companies. Many of these companies were sponsored by, and affiliated with, investment or brokerage houses. During this golden era these financial houses appeared to have a magic touch and there existed throughout the country a tremendous demand for securities of investment companies affiliated with these concerns. It was expected and hoped that the investment companies would participate in the businesses of the financial firms with which they were affiliated. So great was the demand, that most investment company securities promptly sold at large premiums over liquidating values. Control by an invest-

8. An outstanding exception is State Street Investment Corporation, of Boston, which has not issued any new shares or liquidated any old shares for a number of years.

ment house was considered an asset, and stockholders, having faith in the integrity of these firms, felt it to their advantage that the officers and directors and their affiliates should be able to deal freely with the investment companies. With the crash and the subsequent depression, the prestige of the financial community suffered greatly. The necessity of stockholders to realize cash for their stock brought about a condition where the supply was greatly in excess of the demand. Frauds were uncovered on the part of some managements and the stock of investment companies formerly selling at a premium now almost uniformly began to sell at a discount. It was then that the unit trusts, primarily with fixed portfolios, and the open-end companies first came into prominence.⁹ The ability to cash in at liquidating value was an appealing selling point, with the stock of closed-end companies selling at a discount. The emphasis in the selling of these shares was on the diversified portfolio and ready liquidity of each shareholder's interest. Most open-end companies had no banker or broker affiliations, although many were controlled either by their investment advisers or the distributors of their securities or by persons acting in both capacities.

The main abuses which developed in the investment company industry were abuses related to the nature of investment companies and their affiliations.¹⁰ The liquidity of their capital assets made more easy their embezzlement or theft or their use for improper purposes. Dealings between investment companies and affiliated persons, expressly permitted for greater flexibility and to enable the investment companies to share in the theretofore profitable enterprises of those persons, also made possible improper transactions by the unscrupulous. In fact many in the industry came to believe that even in the best of faith dealings as principals between affiliated persons and investment companies were in the main inadvisable and had already voluntarily abandoned this practice. In the open-end field abuse was related mostly to selling. High pressure sales methods were often indulged in. Stockholders were "switched" from one company to another with no apparent advantage except to the salesman who

9. With management at a discount the fixed trusts, offering an interest in a specified list of diversified securities, appealed to many. But experience soon showed their rigidity to be inadvisable.

10. See Sen. Rep. No. 1775 (1940) 76th Cong., 3rd Sess. 6-8.

received a commission at the expense of the purchaser. With the purchase price of stock based on the liquidating value of the preceding day's close, customers were encouraged to purchase on rising markets to the disadvantage of existing stockholders.¹¹ Accentuating the need for regulation, was the fact that the average stockholder of an investment company was likely to be a man of small means and little financial experience.¹²

The original bill to regulate investment companies followed in many respects the pattern of recent federal legislation. Concepts of regulation were borrowed in particular from the Public Utility Holding Company Act,¹³ the Chandler Act,¹⁴ regulating the reorganization of companies in bankruptcy; the Securities Exchange Act;¹⁵ and in some respects the Securities Act of 1933.¹⁶ Precedent could even be found in certain provisions of the banking laws¹⁷ and of the Civil Aeronautics Act.¹⁸ True, the investment company situation had problems of its own for the solution of which there were no precedents to draw upon, and in addition the original bill was in some respects more drastic than any of the precedents referred to. While the bill as introduced contained no "death sentence" for senior securities,¹⁹ senior securities were to be prohibited in the future; reorganizations, even of solvent companies, were to require the approval of the Securities and Exchange Commission; voting rights were to be "equitably" readjusted in the discretion of the Commission; and in general very large discretionary powers as to various types of transactions, almost in the nature of "blank checks," were vested in the Commission.

11. See discussion *infra*, page 330.

12. See Sen. Rep. No. 1775 (1940) 76th Cong., 3rd Sess., 4.

13. (1935) 49 Stat. 803, 15 U. S. C. A. (Supp. 1940) sec. 79.

14. (1938) 52 Stat. 840, 11 U. S. C. A. (Supp. 1940) sec. 201.

15. (1934) 48 Stat. 881, 15 U. S. C. A. (Supp. 1940) sec. 78a.

16. (1933) 48 Stat. 74, 15 U. S. C. A. (Supp. 1940) sec. 77a.

17. Especially the sections relating to the independence of officers and directors, the segregation of investment banking and commercial banking functions and underwriting affiliations. In this connection see (1933) 48 Stat. 193, 188, and 189, 12 U. S. C. A. secs. 78, 377, and 378; (1913) 38 Stat. 273, 12 U. S. C. A. sec. 605.

18. (1938) 52 Stat. 977, 49 U. S. C. A. (Supp. 1940) sec. 401.

19. This had been seriously considered in previous drafts but had been eliminated, together with certain other provisions, upon objections raised by representatives of the industry at conferences had with the Securities and Exchange Commission before the introduction of the bill. At these conferences the principles, but not the actual text, of the proposed bill were discussed.

That there were precedents or analogies in other federal legislation for provisions of the bill which were objectionable to members of the industry, constituted but cold comfort for investment company executives. While most recognized that some measure of regulation was necessary for the protection of investors and was essentially to the best interests of the industry, or was in any event inevitable, the bill as originally introduced could not be accepted. It was generally understood that the bill had little if any chance of final passage in the then current session of Congress. Some believed that there was no need for any action by investment companies and there was a reluctance on the part of many to appear at the public hearings and thus unnecessarily attract attention to themselves. Others believed that the hearings would at least constitute a preliminary skirmish in a campaign which was not to end with that session of Congress and that it was highly desirable that they appear at the hearings and make a record for the future in respect of the proposed legislation. On this basis a relatively small group, acting primarily for themselves but in consultation with others, appeared at the hearings. They expressed their points of opposition to the bill as introduced, but at the same time stated their acceptance of the principle of reasonable legislation and defined in general terms what legislation appeared to them to be appropriate.

Towards the close of the extensive hearings of the Senate Committee, it seemed desirable that there be formulated for the record a concise statement of the principles of regulation which might be acceptable to members of the industry and there was thereupon prepared and presented to the Senate Committee a statement of this character subscribed to by virtually all of the investment companies which had appeared at the hearing.²⁰ It thereafter became apparent that a basis existed for negotiation between the Securities and Exchange Commission and representatives of the industry of a bill which might be acceptable to both. With the approval and encouragement of Senator Wagner, chairman of the Senate Committee, such negotiations were undertaken.²¹ An agreement in principle, set forth in memorandum

20. See the testimony of Mr. Arthur H. Bunker in the Hearings before a Subcommittee of the Committee on Banking and Currency on S. 3580 (1940) 76th Cong., 3rd Sess., 1053 *et seq.*

21. See Sen. Rep. No. 1775 (1940) 76th Cong., 3rd Sess., 1.

form, was arrived at promptly and upon canvassing the leading companies in the industry was subscribed to by them.²² There followed the redrafting of the bill by the staff of the Commission and representatives of the industry.²³ The bill as so redrafted was submitted to the industry and again the endorsement of a large section of the industry was received. The revised bill was thereupon recommended to the Senate Committee jointly by the Securities and Exchange Commission and members of the industry.²⁴ After further hearings, the Senate Committee reported it favorably in substantially the form submitted.

Considerable reluctance was at first encountered in the House to a consideration of investment company legislation at that session, particularly in view of the fact that an early adjournment was expected. However, upon satisfying itself that legislation was desired by both the Commission and the industry,²⁵ and that its passage was still possible at that session, a sub-committee of the House Committee on Interstate and Foreign Commerce, under the chairmanship of Congressman Cole, after familiarizing itself thoroughly with the proceedings before the Senate Committee, held brief hearings and thereafter reported the bill favorably with relatively minor changes. Subsequently the bill was passed in both houses with no opposition.²⁶

The passage of such comprehensive legislation with virtually

22. See Hearings before Subcommittee of the Committee on Interstate and Foreign Commerce on H. R. 10065 (1940) 76th Cong., 3rd Sess., 95 *et seq.*

23. In these negotiations, as throughout the whole proceeding, the Commission was represented by Judge Healy, one of its members, and by Mr. David Schenker who was in charge of the investigation and who is now head of the Investment Company Division of the Commission. Under Judge Healy's general supervision, the revised bill was drafted by Mr. Schenker, assisted by Messrs. John Hollands, Harry Heller, and Mrs. Rella Reznick Swartz. The closed-end companies were represented by the writer and the open-end companies by Mr. Warren Motley of Boston. That each party was impressed with the fairness of the other throughout the whole proceeding was testified to at the Senate Hearings. See Hearings before a Subcommittee of the Committee on Banking and Currency on S. 3580, 76th Cong. (1940) 3rd Sess., 1107, 1130.

24. See Sen. Rep. No. 1775 (1940) 76th Cong., 3rd Sess., 1, 2.

25. See H. R. Rep. No. 2639 (1940) 76th Cong., 3rd Sess., 5.

26. Earlier an effort had been made to place the bill on the unanimous consent calendar of the Senate, at which time the discussion was principally taken up with consideration of the propriety of the procedure, there being little debate on the merits of the bill. See 86 Cong. Rec., June 21, 1940, at 13385.

no debate is probably without precedent.²⁷ The constructive attitude of the industry and the wholehearted cooperation between the Commission and the industry was indeed a significant event.²⁸ Whether or not by endorsing a reasonable bill in the last session more stringent legislation at a later session was avoided, it is the conviction of the writer that the enactment of the Investment Company Act of 1940, particularly as the result of a coöperative effort, was of primary benefit to the investment company industry. The Act not only protects investors, but in setting specific standards for management affords protection to officers and directors as well.

A detailed comparison of the investment company bill as originally introduced with the Act as finally passed will be interesting to some. In evaluating the changes it must be remembered that most open-end companies, as they are constantly selling their securities, are subject to the provisions of the Securities Act of 1933 and to stringent provisions of various Blue Sky laws; that most of the leading closed-end companies and some of the open-end companies are subject to the Securities Exchange Act of 1934, being listed on national security exchanges; that the Act is in essence compromise legislation; and it should be noted that situations prohibited as to the future are frequently not affected to the extent already existing, in part out of deference to the Constitution, in part out of recognition of the injustice of destroying existing rights and in part as the inevitable result of compromise. In general, the industry objected to restrictive or regulatory legislation in respect to matters which were not peculiar to investment companies. In the bill as originally introduced a very large measure of discretion was vested in the Securities and Exchange Commission to formulate standards, to impose restrictions, and to regulate conduct. Under the Act as passed there was vested great discretion in the Commission, but in the main the standards and maximum prohibitions are definitely prescribed and the discretion vested in the Commission is to grant exceptions either by rules and regulations to cover general types of situations or by order in specific cases.

27. It is perhaps only fair to point out that the Congressional mind was then pretty much preoccupied with matters of national defense.

28. See 86 Cong. Rec., August 1, 1940, at 14924; 86 Cong. Rec., August 8, 1940, at 15413.

DEFINITIONS

The major problem in defining an investment company lay in drawing the line between an investment company and a holding company. On the one extreme there is the company whose sole business is the investing and reinvesting of its funds in diversified securities—obviously an investment company—and on the other, the company whose assets consist solely of stock of wholly owned subsidiaries not engaged in the investment business—obviously a holding company.

Except for face amount certificate companies which are not discussed in this article, the Act defines as an investment company any issuer which (1) is, or holds itself out to be, engaged primarily in the business of investing or trading in securities, or (2) is engaged in the business of investing, trading in or *owning* securities and over 40% of whose assets, as therein defined, consists of investment securities, that is, securities other than government securities or those of majority owned non-investment company subsidiaries. This latter is the so-called statistical test for determining whether or not in the first instance companies fall within the investment company or the holding company category. But notwithstanding the effect of this statistical test, no company is an investment company (1) if it is *primarily engaged* directly or through *wholly owned* subsidiaries in a business or businesses other than that of investing, owning, or trading in securities; (2) if upon application the Commissioner finds it to be *primarily engaged* in a business or businesses other than that of investing, owning, or trading in securities either directly or (a) through *majority* owned subsidiaries or (b) through *controlled* companies conducting similar types of business; or (3) if it is a company all of the outstanding securities of which (other than short time paper and directors' qualifying shares) are directly or indirectly owned by a company excepted from the definition of investment company by (1) or (2) above.²⁹

Thus, where an exemption is based on wholly owned subsidiaries the company may itself determine whether or not it is an investment company within the meaning of the Act, while in the other two cases the company must apply to the Commission

29. There have been filed with the Commission over 30 applications for exemption under these provisions.

for an order. The latter procedure, however, has the advantage that if successful the company has the protection of a determination by a competent authority.³⁰ The apparent reason for the more limited exception in respect of controlled companies is that any more general exemption would have exempted from the Act a number of companies of the type believed to require regulation.³¹

It is far from easy in many cases to determine what the primary business of a company may be. Unless at least 40 per cent of the assets of a company, speaking generally, are investment securities, the question does not arise. But possibly over 50 or 60 per cent of a company's assets may be invested in investment securities and still the company may claim that its primary business is something other than such as to bring it within the purview of the Act. Clearly the proportion of assets is not the test, because the exception is based upon the nature of the business primarily engaged in, notwithstanding the result of the statistical asset test. Relative income, gross or net, from various assets may be a factor. As always, it is only the borderline cases that cause difficulty and it is probable that the decisive factor must be the company's own determination of what constitutes its chief business, not a determination made for the purposes of the Act but a determination evidenced by the conduct of its business.

A miscellaneous group of exceptions from the scope of the definition of investment companies relates to companies with less than 100 stockholders, dealers in and underwriters of securities,

30. It is believed that the Commission would be inclined to take jurisdiction to make a determination as to a company claiming exemption under the first provision, upon application by such company, even though jurisdiction to do so is not specifically spelled out in the Act. The Commission is, of course, not bound by the conclusion reached by a company that it is exempt under the first provision, and if the Commission believed that a company which had not registered was included within the jurisdiction of the Act it undoubtedly would, after inquiry, take appropriate steps against the delinquent company.

31. In connection with the language of the exemption—primarily engaged, directly or through wholly owned or majority owned or controlled companies—the question has been raised as to whether the company which is claiming exemption must itself be participating in the business of the subsidiary or controlled companies. It is submitted that for the purpose of this section the business of the subsidiary or controlled company is the business of its parent and that it would defeat the purposes of the exemption if the language were construed to mean that the parent company must itself participate in the business of the subsidiary or controlled companies.

banks and bank holding company affiliates, public utility holding companies, *et cetera*.³²

Investment companies are classified as "face amount certificate companies," "unit investment trusts," and "management companies," the latter as previously indicated being the only type discussed in this article. Management companies are in turn subclassified into open-end and closed-end companies³³ and into diversified and non-diversified companies. A diversified company must have at least 75 per cent of the value of its total assets in cash, cash items, government securities, securities of other investment companies, and other securities limited in respect of any one issuer to an amount not greater in value than 5 per cent of the value of the total assets of such management company and to not more than 10 per cent of the outstanding voting securities of such issuer.³⁴ The 25 per cent reservoir is permitted for purposes of flexibility.

As to the general definitions in the Act, there is in the main little which calls for special comment. Many of the definitions follow closely, if not verbatim, similar definitions in the Securities Act of 1933 and the Securities Exchange Act of 1934. Attention is, however, called to the definitions of the words "affiliated person," "assignment," "control," "redeemable security," "reorganization," and "value."³⁵

32. See also exemptions under sec. 6. In this section is contained one of the most sweeping grants of power contained in the Act: the power given the Commission, by rules and regulations or by order, conditional or unconditional, to exempt any person, security, or transaction or any class or classes thereof from any of the provisions of the Act. Sec. 6(c).

33. See page 305, *supra*.

34. The distinction between diversified and non-diversified companies is due in large part, it is believed, to a desire to inform stockholders of the character of the portfolio of the company in which they have invested. But note restrictions on changing from a diversified to a non-diversified company discussed *infra*, p. 316. Furthermore it was anticipated, and correctly so, that the distinction might be made the basis for difference in tax treatment and the definition of a diversified company in the original bill (sec. 5(b)(1) of S. 3580) was vigorously challenged. The Second Revenue Act of 1940, passed subsequent to the Investment Company Act of 1940, did actually exempt diversified management companies as well as "mutual" companies from the excess profits tax. See sec. 727(d) of subchapter E of the Internal Revenue Code, as added to the Code by Title II of the Second Revenue Act of 1940.

35. The words "affiliated persons," with their pyramided counterpart, "affiliated person of an affiliated person," appear frequently in the Act. The latter is far reaching in scope and often requires elaborate charting to determine its ramifications. So remote may be the connection of an affiliated person that the word "knowingly" has been inserted in many cases

REGISTRATION AND CLASSIFICATION OF INVESTMENT COMPANIES
AND CHANGES IN INVESTMENT POLICY

The Act follows the familiar pattern of prohibiting use of the mails or instrumentalities of interstate commerce to domestic investment companies unless registered and thereafter imposes limitations and restrictions on registered companies.³⁶ Foreign companies are prohibited only in respect of the sale of their securities within the United States, with power in the Commission to permit such sales where it finds it both legally and practically feasible to enforce the provisions of the Act against any foreign company.³⁷

to protect innocent infringements of the Act which are bound to follow from such widespread prohibitions. It is, therefore, important whenever the expression "affiliated person of an affiliated person" appears to diagram carefully the extent to which the applicable prohibitions may apply.

In respect of the definition of "assignment" it should be noted that this includes any transfer of a controlling block of the assignor's outstanding voting securities. Thus an assignment of an investment advisory or distributing contract within the provisions of Section 15 may be effected, not merely by the assignment of the contract itself, but by a transfer of control of the person holding such contract.

The definition of "control" is an attempt to solve the problem caused by lack of definition of this word and consequent uncertainty as to its meaning under other acts. *Prima facie*, the beneficial owner of 25 per cent or more of the voting securities of a company is presumed to exercise control of such company and, conversely, any person who does not own 25 per cent of the voting securities is presumed not to be a controlling person. Provision is made for a determination in a proceeding by the Commission rebutting any such presumption. In the absence of such definition under other acts, the question has arisen whether an individual, because of possible dominating personality, as president, chairman of the board, or director, for example, might be deemed to control a corporation in spite of a relatively small stock ownership. Or whether some individual, because of relationship to some other person, perhaps an employee or a relative, might be deemed to be a controlled person. Important consequences might flow from the fact or absence of control, making certainty of interpretation a matter of prime importance. It should be noted that the word "control" appears a number of times in the important definition of "affiliated person." A natural person is presumed not to be a controlled person.

The definition of "redeemable security" is significant because it is upon this definition that the subsequent definition of "open-end companies" depends. A redeemable security is one, other than a short term paper, under the terms of which the holder is entitled on presentation to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent thereof.

The importance of the definition of "reorganization" lies in the fact that it includes types of transactions which may not commonly be thought of as reorganizations. Substantive results, beyond mere interpretations, are thus effected by definition here as in other places.

This applies also to the definition of "value" which contains substantive provisions effecting the determination of values.

36. See sec. 7.

37. See sec. 7(d).

In general, the information required upon registration follows the requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934, with provision for elimination of duplication.³⁸ In addition every registered company is required to recite its policy as to classification and subclassification, borrowing money, issuance of senior securities, engaging in the business of underwriting, concentrating investments in a particular industry or group of industries, purchase and sale of real estate and commodities, making loans to other persons and portfolio turn-over. The latter must include a statement showing the aggregate total amount of the purchases and sales of portfolio securities in each of the last three full fiscal years. A statement of policy is also required as to any other matters which the registrant elects to treat as a matter of fundamental policy.³⁹ The recital of policy is to contain a statement of whether the registrant reserves freedom of action to engage in any particular type of activity and, if such freedom of action is reserved, a statement briefly indicating in so far as practicable the extent to which the registrant intends to engage therein.⁴⁰

Changes in subclassification from open-end to closed, or vice versa, or from a diversified to a non-diversified company are not permitted unless authorized by a vote of the majority of outstanding voting securities. Nor without such vote may a registered company borrow money, issue senior securities, underwrite securities, purchase or sell real estate or commodities, make loans, except in accordance with the recitals of policy contained in its registration statement or deviate from its policy as to concentration of investments or from any fundamental policy which it has elected to treat as such, nor change the nature of its business so as to cease to be an investment company.⁴¹ In the case of common law trusts where no voting securities are issued, provision is made for corresponding approval of the holders of a majority of outstanding shares.⁴²

38. See sec. 8.

39. See sec. 8(b). The original bill gave to the Commission wide discretion as to information to be required on registration and in determining what should constitute matters of fundamental policy, the latter both in general and as to specific companies. See Sec. 8(b) of S. 3580.

40. The original bill required registration, as well, of officers, directors, and certain other affiliated persons. Sec. 9.

41. See sec. 13(a).

42. See sec. 13(b).

The reason for these provisions would seem obvious. Under existing corporate law it has been possible, and indeed quite generally the practice, to formulate charter provisions of such broad scope as to permit almost limitless discretion in the management as to the types of business to be entered into, even where no exercise of such discretion was contemplated. There have been cases where investment companies substantially changed the nature and character of their business without stockholders' approval or, indeed, without any notice to stockholders and opportunity for objection. The above provisions are intended to meet this problem by preventing any fundamental change in the character of the business to be conducted without stockholders' approval.⁴³

AFFILIATIONS OF OFFICERS AND DIRECTORS, RESTRICTIONS ON
TRANSACTIONS IN WHICH THEY ARE INVOLVED,
AND RELATED MATTERS

The more radical of investment company critics have insisted that investment companies must be segregated from any investment banker, security dealer, broker or similar person, and from any person acting as its investment adviser or distributor of its securities—that is to say, that all such persons should be excluded from acting as officers or directors of investment companies. Further proposed restrictions would have prevented any officer or director of an investment company from being an officer or director of any other investment company, of any bank, or of any corporation whose securities might be held in the portfolio of the investment company.

The charge had been made that investment companies frequently were operated, not primarily in the interests of their stockholders, but in the interests of controlling groups or groups represented on the board of directors. Specifically, there have been instances of investment houses selling securities to affiliated investment companies under circumstances which at worst constituted a conscious unloading of securities on the investment com-

43. It would be possible through the use of broad generalities in the statement of fundamental policies to circumvent completely the purposes of these provisions. On the other hand, too little flexibility in a statement of policy might seriously hamper legitimate operations of an investment company. Accordingly, the rules and regulations and the forms and accompanying instructions to be issued by the Commission under this section will be of great importance.

pany and at best a bad bargain for the investment company. Where the investment company was not bargaining at arm's length, it may have fared badly even though the individuals involved intended to act in good faith and in the best interests of the investment company. Charges were made that securities of investment companies were turned over rapidly, that is to say, frequent switches were made in investments, not with a primary view to the good of the investment company, but with one eye on brokerage commissions to be derived. Distributors of investment company securities who controlled investment companies were said to place undue emphasis on selling to the detriment of management. In fact the conflict-of-interest school went so far as to suggest that any conceivable conflict of interest on the part of an officer or director of an investment company should be outlawed, that any director of an investment company who is also a director of a company whose stock is held by the investment company, no matter in what small amount, must inevitably violate his duties to one or the other or both.⁴⁴

The investigating staff of the Commission, to its credit, approached these problems with an open mind, leaving for determination at the end of the investigation the question of whether or not to recommend the drastic segregation above referred to.⁴⁵ The conclusion finally reached by the Commission was not to recommend such segregation, although proposing safeguards in the way of prohibitions considerably beyond those in the bill as finally enacted. Their investigation had apparently convinced the Commission that the record of so-called independent investment companies was at least no better than that of those with the affiliations referred to and that the major possibilities of abuse could be taken care of in other ways. Perhaps the Commission was also somewhat impressed with the argument that

44. Unfortunately life is full of conflicts of interest and they cannot be eliminated entirely. A lawyer has a code of ethics which guides him under similar circumstances and there is no reason why there cannot be developed, as indeed there has and is being developed, a code of business conduct which will assist honorable men in determining their conduct when questions of possible conflict arise. To the extent reasonably feasible major conflicts should be eliminated. But there is always a question of balancing the benefit against the detriment. The detriment is overwhelmingly large when the result of a prohibition would be to deprive investment companies of the opportunity of obtaining desirable directors by reason of the remote possibility of a conflict of interest.

45. See page 317, *supra*.

securities of some investment companies were sold with the express representation to stockholders that such investment companies would be affiliated with and managed by particular investment or brokerage houses and doubtless bought by stockholders for that very reason. The fact that a number of the practices which seemed undesirable had already been abandoned by many in the industry was undoubtedly also a factor.

The provisions of the Act which deal primarily with the problems just discussed are Section 10, entitled "Affiliations of Directors," Section 15 dealing with "Investment Advisory and Underwriting Contracts," and Section 17 entitled "Transactions of Certain Affiliated Persons and Underwriters."⁴⁶

In the main Section 10, as finally enacted, provides that investment companies must have a minority of at least 40 per cent of directors who are not affiliated with the management⁴⁷ and must have a majority of its directors independent of brokers as a group, principal underwriters of its securities as a group,⁴⁸ and investment bankers as a group.⁴⁹ No investment company is permitted to have a majority of its board of directors consisting of persons who are officers or directors of any one bank, but the few existing situations are left undisturbed in this respect.⁵⁰

The theory of these provisions is (1) that it is desirable that all investment company transactions be subject to the scrutiny

46. See also sec. 9 which disqualifies persons convicted of certain offenses from acting as officer, director, etc. of an investment company.

47. Specifically, who are not "investment advisers of affiliated persons of an investment adviser or, or officers or employees of, such registered investment company."

48. A special exemption is made to take care of the case of an open-end investment company which is managed by an investment advisory firm and whose securities are distributed only to the customers of such firm. Here, in essence, the investment company constitutes merely a medium for pooling and thus managing more economically the investment funds of the firm's customers. In these cases no sales load or commission is permitted on the sale of securities of the investment company and this effectively limits the scope of the exception. See sec. 10 (d).

49. Here as in a number of other sections of the Act there is an express exception in respect of "a company of the character described in sec. 12(d) (3) (A) and (B)." The company referred to is one all of whose stock is held by investment companies, and which is engaged in the business of underwriting and dealing in securities. Obviously no conflict of interest arises where the investment banker is a subsidiary of the investment company.

50. A further provision of sec. 10 limits the purchase by an investment company of securities sold or underwritten by a syndicate where affiliated persons are involved in the syndicate, even though the purchase is not made from the affiliated person.

of at least a minority of directors independent of the management and (2) that in cases where affiliations of directors might involve conflicts of interest, stockholders are entitled to the protection afforded by the existence of a majority of disinterested directors. This latter protection, coupled with the specific prohibitions on certain transactions of directors and affiliated persons and the other safeguards of the Act,⁵¹ was deemed sufficient.

Several questions have already arisen under Section 10. For example, is general counsel for an investment company an employee and therefore, if a director, one who cannot be included in the requisite number of those independent of the management? In the opinion of the writer, a lawyer is not usually an employee, although he might be under particular circumstances, such as if his sole employment were by the investment company.⁵² Whether former employees or former partners of brokerage, banking, or investment advisory firms can qualify as directors independent of these firms, is a question which has also arisen. Clearly under the language of the Act, such persons can so qualify unless there has been a determination that they are persons controlled by such brokerage, banking, or investment advisory firms.⁵³ However, investment companies have wished to be sure that they were complying not merely with the letter but also with the spirit of the Act. As to whether the spirit of the Act is complied with in any given case would seem to depend upon the particular facts of that case. After all, a former partner of a banking house may in fact be decidedly more independent of such firm than, say, an insurance broker who receives large amounts of insurance business through that firm. The Act, in discarding extreme remedies and taking a middle course, presupposes good faith on the part of the investment companies and their managements. In the long run it will be the measure of good faith with which the industry endeavors to live up to the spirit of the Act which will determine to what extent moderate governmental regulation can be successful and to what extent,

51. For example, the requirements of disclosure through reports and the general supervisory powers of the Commission discussed *infra*, pages 340-341, 343.

52. In view of the doubts expressed by the Commission on this subject, it is unlikely that any investment company will wish to include counsel, or members of any firm which is counsel, in the category of directors independent of the management.

53. See definitions of "affiliated person" and "control," secs. 2(a)(3) and 2(a)(9).

granting the need for regulation, extreme measures may be necessary.

Section 17 of the Act supplements the provisions requiring so-called independent directors, with specific prohibitions against certain transactions with affiliated persons. Thus no affiliated person, promoter of or principal underwriter for a registered investment company or any affiliated person of such person, promoter, or principal underwriter, may knowingly sell any security or other property to or borrow any money or purchase any security or other property from such registered company or any company controlled by such registered company.⁵⁴ There is excepted from the prohibition against sale, securities of which the buyer is the issuer (so that the investment company may purchase its own stock from affiliated persons as well as others⁵⁵), and also securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities. As the prohibition is primarily designed to prevent special transactions on the part of insiders of which stockholders may never be advised, this latter exception is obviously reasonable as well as desirable. The limitation on purchases from investment companies does not apply to securities of which the seller is the issuer. Any sweeping prohibition may involve hardship and unreasonable restraints and instead of protecting stockholders may, in specific cases, work to their disadvantage by preventing desirable transactions. Accordingly, the Act provides that upon application the Commission may exempt any proposed transaction from the above described provisions if it finds that its terms, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned and that the proposed transaction is consistent with the policy of each registered investment company concerned and with the general purposes of the Act.

Section 17 further regulates participations by investment companies in underwritings of affiliated persons and limits the commission which any affiliated person may receive when acting as broker for an investment company. While he may act as broker in the distribution of securities owned by an investment com-

54. Note exception in respect of a company described in 12(d) (3) (A) and (B). See note 49 *supra*.

55. See sec. 23 (c) discussed at page 329, *infra*.

pany, he cannot act as distributor if the transaction takes such form that the affiliated person buys for his own account in making the distribution. To the extent that this distinction may not be one of substance, it is possible that rules and regulations may be promulgated permitting an affiliated person to act as distributor even in cases where the transaction takes the form of a purchase by him from the investment company.

One major question of interpretation has already arisen in connection with the foregoing provisions. In a proposed merger between an investment company and a company affiliated with it, the point was raised as to whether this would require the approval of the Commission on the ground that the merger might be deemed to involve a "sale" by an affiliated person to an investment company. In this connection note that by definition the word "sale" includes "any disposition."⁵⁶ However, in view of the definition of the word "reorganization"⁵⁷ and the section dealing specifically with that subject,⁵⁸ the legislative history of the Act which shows the abandonment of the proposal that the Commission be given general power to pass on reorganizations,⁵⁹ and the particular use of the word "sell" throughout Section 17, the writer does not believe tenable the suggestion that a merger comes within the prohibition on sales. Such view seems to have been accepted at least tentatively by the Commission.

A further provision of Section 17 makes unlawful any charter, by-law, or other provision which purports to protect any director or officer of an investment company and certain other persons against liability for wilful misfeasance, bad faith, gross negligence, or reckless disregard of his duties. This appears simple enough on its face, but it has given rise to the question of whether it affects proposals to provide for indemnity to directors for counsel fees incurred in successfully defending themselves against unjust litigation. The wording of any such provision must be scrutinized in reference to this section of the Act. Furthermore, existing clauses in charters permitting directors to deal as principals with investment companies, whether or not such clauses purport to protect them from liability as to any such

56. See sec. 2(a) (33).

57. See sec. 2(a) (32).

58. See sec. 25.

59. See discussion *infra*, pages 339-340.

dealings conducted in good faith, require reappraisal. To the extent that any action under a charter provision of this sort is in violation of the express prohibitions of the Act, any such action would, of course, be unlawful under federal law. However, in a civil suit brought against directors in a state court, such a charter provision might well be upheld and the directors relieved of liability. On this basis it would seem that a charter clause of this character is in violation of the prohibition against exculpatory clauses which protect directors against wilful misfeasance—*i. e.*, a violation of the Act.

Section 15 regulates investment advisory and distributing contracts. These are permitted for periods of two years only, but may be renewed annually thereafter by action of the board of directors. An investment advisory contract must have been initially approved by a majority vote of stockholders and must be subject to termination at any time on sixty days' notice. Both types of contract must be subject to automatic termination in the event of their assignment by the investment adviser or distributor.⁶⁰ Contracts in existence prior to March 15, 1940 are permitted to run until March 15, 1945.

At least one provision of the original bill received more or less universal approbation. That was the provision now found in Section 16 (a) stating that no person may serve as a director of a registered investment company unless elected by stockholders at an annual or a special meeting duly called for that purpose, except, in effect, that vacancies occurring between such meetings, not in excess of one-third in all, may be filled in any otherwise legal manner. This provision, it was universally agreed, should prevent the recurrence of a situation which had on several occasions led to serious losses to stockholders. Directors had turned over control to a new board without stockholders' action, and indeed without notice to stockholders, by the familiar procedure of successive single resignations of directors immediately supplanted by new members.⁶¹

It is true that even with this provision, voting control of an investment company could be purchased by unscrupulous persons who could thereupon elect new directors and presumably have

60. See definition of "assignment" discussed in note 35, *supra*.

61. See *Gerdes v. Reynolds*, decided by the New York Supreme Court on February 18, 1941, and as yet unreported.

the company operated to their advantage rather than in the interests of stockholders. Under Section 16 stockholders are at least put on notice of any proposed change and a regular corporate vote is required for such purpose. Experience has shown that the most scandalous practices were possible only where the new management, which proposed to acquire its control with the funds of the corporation itself, could step in without any delay. Such delay, with stockholders' meeting regulated by the proxy machinery, should go a long ways towards preventing at least flagrant abuses and to giving dissatisfied stockholders sufficient opportunity to avail themselves of normal legal remedies. It is not possible, nor was it intended, that the Act should prevent every conceivable abuse.⁶²

FUNCTIONS AND ACTIVITIES OF INVESTMENT COMPANIES

Under the heading "Functions and Activities of Investment Companies" Section 12 of the Act deals with certain restrictions on the activities of these companies. Closely related is subsection (c) of Section 20, dealing with circular ownership. Section 21, having to do with loans, is also somewhat related.

Section 12 prohibits a registered investment company, in contravention of rules and regulations prescribed by the Commission and with certain exceptions (1) to purchase any securities on margin, (2) to participate on a joint or a joint and several basis in any trading account in securities, or (3) to effect a short sale of any security. It seems hardly necessary to comment on these restrictions except to state that it is doubtful whether many investment companies would be likely to indulge in any of these prohibited transactions quite aside from the statute.⁶³

Open-end investment companies are prohibited from acting as distributors of their own securities, except through an underwriter, in contravention of rules and regulations prescribed by the Commission. Apparently the Commission was particularly fearful of the possibility that open-end investment companies in their formative stages might be made to shoulder the unprofit-

62. Sec. 16(b) was designed to give some measure of protection in respect of the few existing true trusts, in the strict legal sense, where no provision exists for the election of trustees.

63. Note that these prohibitions are expressed as in contravention of rules and regulations prescribed by the Commission. This formula is contrary to the general pattern of the Act. See discussion *infra*, pages 344, 346.

able burden of selling and distributing their shares during this period of heavy expense and small return, building up the investment company for the benefit of some controlling person.⁶⁴

The most important prohibition in Section 12 is that designed to prevent pyramiding. Investment companies are prohibited from acquiring stock of other investment companies which would result in a holding of more than 3 per cent of voting stock in the case of a general investment company, and 5 per cent in the case of a company whose policy is to concentrate its investments in a particular industry or group of industries. An exception is made in the case of investment companies already owning 25 per cent or more of the outstanding voting stock of another investment company. As 25 per cent is viewed as representing working control, acquisitions beyond that amount are considered beneficial, tending in the direction of ultimate consolidation of the companies involved. The Act leaves undisturbed existing pyramided systems. Similar provisions prohibit purchase of stock of insurance companies, except that 10 per cent is the limit in this respect.

These provisions effectually put an end to future pyramiding of investment companies with their attendant evils, consisting of (1) the acquisition of control over large aggregations of capital through relatively small investment in one company whose assets are in turn used to purchase control of another company and so on; (2) the possibility of excessive volatility in the securities of the top company through pyramiding leverage upon leverage; and (3) the complexity of the structure with the resultant difficulty on the part of the uninitiated stockholder in appraising the true value of his security.⁶⁵ This complexity and some of the

64. Sec. 12(c) limits underwriting commitments permissible for diversified investment companies to conform to the general qualifications as to diversification applying to such companies.

65. Note sec. 14 dealing with size of investment companies. In the Act as originally introduced investment companies were limited to definite dollar amounts as to size, varying as to the classification within which they fell. Two prime motives seem to have been behind this restriction: (1) the desire to provide a link in the chain of sections designed to restrict the control over other companies exercised by any one group, and (2) the feeling that too large an aggregation of capital could not be efficiently managed. The proposed size limitations were necessarily and admittedly more or less arbitrarily fixed. The industry was opposed to any limitation in size, taking the position that it was virtually without precedent and arguing that any dollar limitation might become meaningless in case of inflation or other devaluation of the purchasing power of the dollar. The

evils above mentioned are magnified through cross and circular ownership prohibited under Section 20.

It was deemed unwise that an investment company should be a part owner, except with other investment companies, in a concern conducting a business of underwriting and dealing in securities and, accordingly, any such ownership is prohibited. While this is a limitation on the permitted activity of investment companies and appears in Section 12(d) (3), perhaps the prime evil aimed at is one relating to possible abuse of position by affiliated persons. It was, of course, recognized that if investment companies were permitted themselves to engage in the business of underwriting, there was no reason why, and possibly it was more desirable that, they should conduct this business through an underwriting subsidiary. In fact special exemptions from prohibitions on affiliated persons are contained throughout the Act in respect of this type of corporation.⁶⁶

A special exemption from the prohibition against acquiring stock in other investment companies is made as to a corporation which might be organized with an aggregate capital not to exceed \$100,000,000 to engage in the business of underwriting, furnishing capital to industry, and financing promotional enterprises. A company, to qualify under the exception, must have only one class of stock, all of which must be issued to investment

matter was settled by the insertion of the provision of sec. 14(b), giving the Commission authority to make a study of the subject at any time that it thought that substantial *further* increase in size of investment companies created a problem.

The other aspect of the question of size was that of a minimum size. Both Commission and industry agreed that a minimum size was desirable, primarily for the reason that the expense of operation of an investment company on any proper basis could not be borne by a company with insufficient assets. Another reason was to discourage irresponsible persons from attempting to organize investment companies. The minimum size provided for is \$100,000, which amount is entirely inadequate to sustain the costs of a properly run investment company. But this seemed to be the largest amount that it was expedient to suggest. Even so this provision met objection in the House Committee on Interstate Commerce, from a member who believed that there was a real need in small communities for local investment companies of a type not generally contemplated by the Act. In these situations some local personage, enjoying the confidence of the community, might manage without any staff and on a part time basis investment funds of his neighbors, placing them primarily in local mortgages and possibly in local business enterprises. To take care of this type of case the exemption provided for in sec. 6(d) was inserted in the Act. See Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce on H. R. 10065 (1940) 76th Cong., 3rd Sess., 117-120.

66. See sec. 12(d) (3) (A) and (B).

companies, and no investment company is permitted to put more than 5 per cent of its assets in such company. It was hoped that this provision might pave the way for investment companies themselves to pool a portion of their assets to engage in promotional activities, particularly in the light of the needs of national defense.

Under Section 21 no registered management company is permitted to lend money to any person if such person controls or is under common control with such registered company, nor in contravention of any statement of policy to the contrary. This prevents in effect what is known as upstream loans, that is, loans from a subsidiary to a parent or to some company controlled by the parent. But there is excepted a loan from a registered company to a company which owns all of the outstanding securities of the registered company, as in that case there are no outside interests to be considered.⁶⁷

DISTRIBUTION AND REPURCHASE OR REDEMPTION OF SECURITIES

Section 22 deals with distribution, redemption, and repurchase of redeemable securities, that is to say, of the securities of open-end companies, and Section 23 with the distribution and repurchase of securities of closed-end companies.

Section 23 provides that no registered closed-end company shall issue any of its securities for services or for property other than cash or securities,⁶⁸ or shall sell any common stock of which it is the issuer at a price below the current net asset value of such stock except (1) in connection with an offering to the holders of one or more classes of its stock, (2) with the consent of a majority of its common stockholders, (3) upon conversion of a convertible security or upon the exercise of outstanding warrants,⁶⁹ or (4) under such other circumstances as the Commission may permit. It is evident that the prohibition against issuing securities for services or property other than cash and securities was designed to eliminate the possibility of overreaching or fraudulent practices on the part of so-called insiders. While theoretically there might be occasions when the issue of securities for such consideration would be justified and in the best

67. See corresponding provision of sec. 17(a) (3).

68. Except as a dividend or distribution to its security holders or in connection with a reorganization.

69. Future issuances of warrants are restricted under sec. 18.

interests of the company, it did not seem likely that such occasions would be frequent or that any serious inconvenience would result to legitimate operations from such a prohibition. On the other hand, the possibility of abuse was recognized and consequently no objection was voiced to these provisions.

In connection with the prohibition against the sale of common stock below current net asset value, it should be borne in mind that except in unusual situations there would be no such necessity for or advantage in obtaining additional capital as to warrant the sale of common stock at a price which would dilute the equity of existing common stockholders. Unlike an industrial, an investment company seldom has urgent need of additional capital. An exception would be a situation in which additional assets were required to prevent a default on the company's notes under a touch-off provision,⁷⁰ in which event it is altogether unlikely that common stock could be sold at all, or a case in which an investment company desired to invest in some enterprise with seeming opportunities of great profits for which it had insufficient capital. These situations would be rare and, if the necessity arose, could be taken care of by the authority granted to the Commission to grant exceptions by rules and regulations or orders. On the other hand, the investigation of the Commission had found that the issuance of common stock to favored persons at less than true value was not an imaginary evil.

Section 23 further provides that no registered closed-end company shall purchase any securities of which it is the issuer except (1) on a securities exchange or such other open market as the Commission may designate, (2) pursuant to tenders, and (3) under such other circumstances as the Commission may permit. In the event of purchases on the open market, the purchasing investment company must have informed its stockholders of its intention to purchase stock within the preceding six months.

The purpose of these provisions must be clear. At one time the Commission had some doubt as to whether an investment company should be permitted to purchase its stock at all. But the almost universal practice in this respect, on the one hand giving the investment company the opportunity of profit if able to purchase its stock at a discount below asset value and, on

70. A provision similar to a margin requirement.

the other hand, affording a market to stockholders who might not otherwise be able to dispose of their stock, seemed reasonable so long as safeguarded by adequate protections. If purchases are made on the open market or pursuant to tenders, in each case after adequate notice, every stockholder has an equal opportunity to sell. Affiliated persons should have the same right as others to take advantage of the corporation's desire to purchase its own stock and these transactions are excepted from the provisions of Section 17 (a). It is true that by these provisions the corporation is cut off from favorable opportunities to make special deals for large blocks of stock, an opportunity which is particularly likely to arise in view of the present distress of foreign security holders. However, here, as in so many other cases, flexibility is maintained by authority in the Commission to grant exceptions.⁷¹

The question has been raised as to whether the call for redemption of preferred stock or bonds constitutes a purchase falling within the above restrictions. But under normal circumstances it would seem clear that a call of preferred stock is a redemption or liquidation and not a purchase and a call of bonds is a payment rather than a purchase within the meaning of this section. This view, it is understood, has been accepted by the Commission. A more difficult situation arises in respect of the designation of an open market other than a securities exchange. It was felt that a proper definition of or the establishment of appropriate restrictions in connection with any designated open market was a matter which would require further investigation and as to which it was doubtful whether any fixed statutory standards should be set. This seemed to be the type of quasi-legislation which, in view of the need for flexibility, could best be left to the rules and regulations of an expert body rather than prescribed in rigid form by Congressional enactment.⁷²

Section 22 of the Act which deals with the distribution, redemption, and repurchase of the stock of open-end companies, is one of the most important sections in so far as open-end companies are concerned. This is because in the case of open-end

71. A number of applications have already been granted permitting special transactions of this character.

72. There seems to be a real question as to whether the Commission will find that any open market exists, other than a national securities exchange, which affords adequate protection for the purposes of this section.

companies there is a constant process of redemption of outstanding shares and sale of new shares. The ability to sell new shares affects the very existence of open-end companies. Accordingly, the company itself, as well as the distributors of its shares, has every incentive to promote sales. Under these circumstances, and with keen competition between companies in the sale of their shares, it was natural that some questionable practices should have developed. It furthermore became extremely difficult, and in some instances impossible, for any one company or small group of companies to raise standards and at the same time compete with the others.

The major complaints were directed against so-called "dilution," the payment of excessive commissions to distributors and dealers, and the character of supplemental sales literature.⁷³ "Dilution" refers to dilution of the equity of existing stockholders in the assets of an investment company caused by the sale of new stock at a price to the company below its then per share asset value. The stocks of open-end companies are theoretically sold at asset value, plus a premium or loading charge to cover the amounts paid to distributors and dealers for the distribution of the stock. As the purchaser thus pays for the selling cost, to the extent that the fact coincides with the theory, the investment company receives full value for its stock and no dilution occurs. However, it has been the general practice of open-end companies to sell their shares during a particular day on the basis of the per share liquidating value at the close of the previous day. Accordingly, when sales are made on a rising market, the liquidating value per share on the day of sale is higher than the purchase price received by the company and a dilution occurs. As it is obviously to the advantage of the purchaser to buy stock on a day when its liquidating value has risen above that on which its price is based, and as a salesman is not likely to let pass unnoticed any particular benefit to his prospective customer, it is not unnatural that by and large the sale of stock of open-

73. Sec. 24(b) requires that copies of all sales literature be filed with the Commission. Under the Securities Act of 1933, provided that a prospectus meeting the requirements of the Act is delivered in connection with the sale of a security, supplemental sales literature is free of supervision. While the original bill required that all sales literature be subject to the same scrutiny by the Commission as a prospectus, the Act merely requires filing of such supplemental sales literature on the theory that this in itself will tend to curb excesses.

end companies is heaviest in days of rising markets. Thus what might be a negligible dilution if it occurred only in isolated cases, is of substantial significance when it becomes the general rule. On days of extreme upward movements of stock prices this dilution in some cases reached very large proportions.⁷⁴

It was charged that in some instances purchasers of open-end shares on a rising market, by immediately redeeming their shares, made profits with no risk to themselves whatsoever. This was almost impossible for the public, because of the premium paid over liquidating value. But officers and directors, when permitted to purchase directly from the corporation and thus eliminate the selling commission, and the principal underwriter or distributor who normally purchases directly from the corporation, have been in position to indulge in this so-called riskless trading at the expense of existing stockholders.

The remedies proposed were (1) against dilution, to require the computation of the selling price as of a time more nearly reflecting the true value of the stock; (2) against riskless trading, to permit sales without loading charge or premiums only to distributors and to distributors only in connection with resales to dealers and customers; and (3) as to excessive selling premiums, to prohibit these. The original bill gave the Commission jurisdiction in these matters.

The open-end companies and the distributors of their securities, however, asked to be given an opportunity themselves to "police" their industry and to correct existing abuses of the character described. The medium proposed was the National Association of Security Dealers, registered under the so-called Maloney Act.⁷⁵ It was agreed that they should be given a period of one year to make this attempt without interference by the Commission and that at the expiration of one year the Commission should have similar powers. If the Commission was then not satisfied with the regulations promulgated by the Association it could step in and promulgate its own rules and regulations.

Accordingly, Section 22 (a) and (b) gives to a securities association registered under Section 15(a) of the Securities Ex-

74. On September 5, 1939, when the general market advanced some twelve points, a number of companies stopped selling their shares to prevent further dilution of the interests of existing stockholders.

75. 15 U. S. C. A. (Supp. 1940) sec. 78o(a).

change Act of 1934 power to prescribe (1) methods, including the time of calculation, for computing the price at which a member may purchase or sell redeemable securities from or to any investment company; (2) a minimum period of time to elapse between the issue of any such security and its redemption by a member; and (3) in effect, to regulate the commission, discount or spread chargeable by members.⁷⁶ Section 22(c) gives like jurisdiction to the Commission after one year from the effective date of the Act.

Other provisions of Section 22 limit the suspension by an investment company of the right of redemption and its right to restrict the transferability or negotiability of any of its shares. Open-end companies are also prohibited from issuing its securities for services or for property other than cash and securities, except as a dividend or distribution to its security holders or in connection with a reorganization.

CAPITAL STRUCTURE

The question of the capital structure permissible for an investment company was a highly controversial subject. The more radical believed not only that no senior securities should be permitted in the future, but that the Act should contain a "death sentence" for these securities, that is to say, should set a time limit during which existing senior capital must be liquidated. Closely allied to the question of senior securities was that of voting rights, for in many cases investment companies were controlled either completely or for all practical purposes by the common stock or by a special issue of common stock, even though the assets of the corporation were insufficient to liquidate its senior securities. In many instances this distribution of voting rights—criticized as inequitable—was due to the fact that drastic

76. Proposed rules, drafted by the National Association of Security Dealers, Inc., prohibit unfair selling commissions; require the calculation twice daily of net asset value in connection with sales; prohibit members from withholding the placing of customers' orders for the purpose of themselves profiting as the result of such withholding; prohibit members from purchasing from any open-end company securities of which they are underwriter except for the purpose of covering purchase orders already received or from an underwriter other than for investment or to cover purchase orders already received. As the jurisdiction of the Association is only over its members the effectiveness of these prohibitions is supplemented by a provision which in effect prevents members from distributing through or acting as dealers for non-members.

shrinkages in market values had, for the present at least, wiped out all value for the junior stock which by its terms had constituted a cushion or safeguard for the senior security.⁷⁷ In other cases, it is true, control was placed from the start in a small group of stockholders, either the common stock as a whole, or a special class of common stock, sometimes having relatively little investment in the corporation.⁷⁸ In respect of this voting situation also, it was the position of the more extreme that drastic remedial legislation and reshuffling of voting rights was called for.

These matters had been discussed by representatives of the industry with the Commission in conferences held prior to the introduction of the original bill, and the Commission had come to the conclusion that, while it would propose that no senior securities be permitted to be issued in the future, it would not suggest a death sentence on those already existing. As to voting rights, its recommendation was that it be given the power to compel an equitable redistribution, that is to say, a reshuffling of voting rights.⁷⁹

The industry opposed vigorously in the Senate hearings and in later negotiations with the Commission a prohibition on future issues of senior securities and the proposal to redistribute voting rights. While the first presented no immediate practical problem to the investment companies represented at the hearings, except in relation to possible refundings or reorganizations, yet the proposal seemed wrong on principle and perhaps too was regarded as an unjustified reflection on existing senior securities. As to the reshuffling of voting rights, this seemed to the industry an unwarranted interference with contract rights of stockholders.⁸⁰

77. At the time of the organization of a corporation, with substantial assets behind the common stock, the voting rights of stockholders may have been fairly distributed in relation to capital contribution. A subsequent drastic decline in market value, however, may have wiped out the asset value of the common stock, leaving it with nothing but its voting rights and a hope for the future.

78. While such a set-up is now quite generally criticized, it must be remembered that in many cases this form of structure was not only accepted but welcomed by stockholders as a means of insuring control of the corporation by a trusted group.

79. See sec. 18, S. 3580 (1940) 76th Cong., 3rd Sess. Note that in giving the Commission authority to force "an equitable redistribution of voting rights and privileges" no real standards were set.

80. As previously indicated, in many cases the common stockholder by the terms of the charter, in other words his contract with the preferred

Ultimately, by agreement with the Commission, the proposal for redistribution of voting rights was eliminated and future issues of senior securities were not prohibited, but were regulated. As to closed-end companies, in the future senior securities could only be issued if at the time of issue they had an asset coverage of 300 per cent if an indebtedness, and 200 per cent if a preferred stock. In connection with the future issue of indebtedness the Act requires that there be prohibited the declaration of any dividend or the purchase of any capital stock unless the indebtedness should have an asset coverage of 300 per cent at the time of such dividend or purchase, with an exception permitting dividends on preferred stock where the coverage on the indebtedness is at least 200 per cent. It is also required that provision be made for voting rights to holders of the indebtedness where its asset coverage is less than 100 per cent or, in the alternative, that a default shall have been deemed to have occurred where the asset coverage shall have been less than 100 per cent for each of twenty-four consecutive months.⁸¹ Future issues of preferred stock are to be protected by a prohibition against payment of any dividend upon or purchase of any common stock unless the preferred stock had an asset coverage of 200 per cent and by the stipulation that they be given certain voting rights.⁸² It is required that dividends be cumulative and that any future preferred stock shall have complete priority over any other class as to distribution of assets and payment of dividends.⁸³ Only one class of funded indebtedness (other than short term loans) is permitted, and only one class of preferred stock. Provision is made for refunding of existing senior securities and for issuance of senior securities on reorganization in amounts

stockholders, placed in jeopardy and actually lost his entire investment for the protection of the preferred stockholder. This same contract, however, gave him certain voting privileges and it seemed to him unjust that he should lose both his asset value as provided for in his contract and his voting rights in spite of his contract. In this discussion the words "constitutional rights" could be heard but without too much conviction.

81. The reason for the alternative was that it was realized that practical difficulties under state law might make it impossible to give to the holders of the indebtedness the voting rights referred to.

82. The right as a class to elect two directors at all times and a majority in the event of default in dividends equal to two years' dividend requirements; also certain voting rights in connection with proposed reorganizations.

83. Thus participating preferred stocks or stocks preferred as to assets but not as to dividends, or vice versa, were prohibited.

comparable to those pre-existing, irrespective of the above provisions. Warrants are prohibited as to the future, except short term warrants issued exclusively and ratably to a class or classes of a company's securities.

For the most part existing open-end companies did not have senior securities, and these are prohibited. Almost all agreed that it was unsound to have outstanding an issue of bonds or preferred stock, where the common stock was subject to redemption at the will of the stockholder, for the equity could thus be taken away completely from behind the senior security. Provision is made, however, permitting bank borrowings by open-end companies provided that a 300 per cent asset coverage is kept at all times.⁸⁴

Subsection (i) of Section 18 in effect provides that all common stock hereafter issued must have equal voting power. In line with this policy of insuring votes to stockholders, voting trusts as to the future are prohibited.⁸⁵ Existing voting trusts are permitted to run out but may not be renewed.

DIVIDENDS

Dividend restrictions in connection with the future issue of senior securities have already been discussed.⁸⁶ The remaining provisions as to dividends are simple, at least on their face. Any company making a distribution to stockholders other than (1) out of undistributed net income, not including profits or losses realized on the sale of securities or other property, or (2) out of such company's net income so defined for the current or preceding fiscal year, must accompany the dividend by a written statement which adequately discloses the source or sources of such payment.⁸⁷

This provision of the bill in its final form is based on the premise that, subject to limitations of state law, the question of dividend payment is a matter of internal management which should be left to the discretion of the board of directors of an

84. In the case of bank borrowings it is relatively simple to maintain the prescribed ratio at all times.

85. Sec. 20(b).

86. See page 334, *supra*.

87. Sec. 19. The original bill permitted dividends on junior securities, only if certain prescribed asset ratios were maintained for securities senior to them. Discretion to vary these ratios within limits was vested in the Commission.

investment company, but that stockholders should be properly advised as to the nature of the distributions which they receive.⁸⁸ Questions entering into a decision as to whether or not to pay dividends in a given instance are much too complex and involve too many factors in which there is room for the reasonable exercise of discretion to permit of rigid statutory standards or prohibitions. For example, whether or not to pay dividends on a preferred stock in excess of earnings involves consideration of a number of factors. Where preferred dividends are in effect paid out of capital funds, if the assets of the company are more than sufficient to cover the preferred stock, such dividends paid to the preferred stockholders are in substance distributions made from the capital of the common stock. If the preferred stock is insufficiently covered, preferred dividends paid out of capital are a return to the preferred stockholder of his own capital with the obligation remaining, of course, to make good the capital impairment. In both cases it must be assumed that an "artificial" surplus has been created by stockholders for the express purpose of permitting the making of these distributions. A factor in connection with the payment of dividends to preferred stockholders, where not earned, may be the nature of the company's portfolio. For example, the company may have adequate assets to earn the preferred dividend, if such assets are wholly invested in income-bearing securities and yet the management may decide, primarily for the benefit of the common stockholders, to place a large part of the corporation's capital in non-income bearing securities in the hope of greater appreciation. Or it may be that large amounts of cash are held in the expectation of a serious market decline, thus reducing the income of the company.

Where there is no senior security, the considerations entering into the payment of dividends are apt to be less complicated. In the case of open-end companies there is a special situation which must be borne in mind. These companies in selling securities at asset value commonly allocate to dividend distribution

88. After extensive conferences with representatives of the National Committee of Investment Companies and with a committee of accountants, the staff of the Commission has formulated, and the Commission promulgated, rules governing the method of calculating the source of dividend payments. See Rule N-19-1. The fact that this has been no easy task emphasizes the undesirability of trying to legislate rigid prohibitions in respect of dividend payments.

account that portion of the consideration received which represents a pro rata share of the accumulated income of the corporation. When the new stockholder receives his first dividend he will be receiving, in part at least, a return of his purchase price. If this were not done and his dividend were paid solely out of true income, existing stockholders would be prejudiced by the admission of a new stockholder. Similarly, upon redemption of a share there is charged to the dividend distribution account that portion of the redemption price which represents the stockholder's pro rata share of the income to date. Tax considerations also play an important part, particularly as to open-end companies. To qualify as a "mutual company," which is virtually relieved of federal income taxation, an open-end company must distribute all of its taxable earnings.⁸⁹ But such earnings, including current profits on sales of securities irrespective of accumulated deficits, may have little relation to investment company concepts as to amounts properly distributable.

In considering the dividend problem of investment companies, it should be remembered that an entirely new concept of earnings appropriate for dividends has developed in recent years. State laws governing the payment of dividends, as in other corporate matters, do not generally distinguish between investment companies and industrial companies.⁹⁰ In respect of corporate income, for example, the normal concept includes or deducts, as the case may be, profits or losses from the sale of securities as well as other assets. If an individual investor owns securities, he will receive the income from such securities irrespective of losses which may be realized on switches of investments. He

89. See Revenue Act of 1938, 52 Stat. 447, 552, c. 289 26 U. S. C. A. sec. 361. The special treatment accorded "mutual investment companies" dates from 1936. See Revenue Act of 1936, 49 Stat. 1648, 1669.

90. In the development of investment company practices in the last two decades one of the major problems has been the application to investment companies of concepts of corporate law evolved in respect of industrial companies. In many instances these did not particularly fit. For example, the purchase by a corporation of its own stock, a common practice with investment companies, had but limited precedent under corporate law as applied to industrial companies. Furthermore, concepts of capital and surplus as related to dividend payments, were based upon assets, largely fixed, not readily marketable, and not subject to large and sudden fluctuations in values. As against this, the quoted market values of an investment company's assets are likely to fluctuate violently in short spaces of time, so that a large surplus existing at the time of a dividend declaration might have disappeared by the payment date, only a few weeks later.

will not be particularly pleased with his holdings in an investment company if he cannot receive his share of the current income earned on dividends and interest because of capital losses suffered.⁹¹

But there can be no doubt that the stockholder should be properly advised as to the source of any dividends which he may receive. The furnishing of such advice has been a practice fairly generally followed by investment companies in the past, partly as the result of stock exchange standards, partly as the result of Blue Sky requirements, and partly as the result of the recognition by the industry itself of its desirability. Were a stockholder not properly informed, there might be opportunity for the unscrupulous unduly to stimulate the price of stock through heavy distributions by way of dividends not warranted and not properly explained. This perhaps is largely theoretical in respect of closed-end companies, as the "market" is peculiarly wise. However, in relation to the distribution of open-end securities where high pressure sales tactics have at times been used on unsophisticated persons, large dividend payments, where not warranted, could be and undoubtedly have been used to stimulate sales. True, the extent to which the average individual is enlightened by the vast amount of information shoved at him by the various securities acts is problematical. But experience seems to indicate that the requirement that such information be given has a salutary effect on corporations and managements, particularly when such information is subject to the scrutiny of a federal agency.

PROXIES AND PLANS OF REORGANIZATION

The section dealing with proxies is completely at variance with the general approach of the Act. There is prohibited the solicitation of proxies in respect of securities of registered investment companies in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Contrary to the general structure of the Act, this legislation is

91. It is true that during the period of rising prices in the 1920's when the question was not that of deducting losses from current income, but of adding capital gains to such income, the problem was not particularly appreciated and investment companies, just as individuals, were only too happy to look upon these profits as real additions to income.

not detailed and not even general standards are prescribed. The pattern and text is that of the Securities Exchange Act of 1934, giving almost unlimited discretion to the Commission. However, this section was accepted by the industry because most of the companies directly represented in the drafting of the Act were subject to the proxy regulations under the Securities Exchange Act of 1934 and therefore the question was pretty much academic.

In respect of plans of reorganization, the Act provides that all proxy or similar material must be filed with the Commission for its information within twenty-four hours after the commencement of any solicitation; that the Commission is authorized, if so requested by any company which is the subject of reorganization or by the holders of 25 per cent of any class of its securities, to render an advisory report as to the fairness of any such plan; and finally that the Commission is authorized to bring proceedings in a United States District Court to enjoin the consummation of any plan of reorganization upon showing to the satisfaction of the court that any such plan is grossly unfair or constitutes gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of the registered company or other sponsors of the plan. In bringing any such proceeding the authority in the Commission is to act on behalf of the security holders of the investment company.

Under the original bill no plan of reorganization of an investment company could be consummated except after proceedings before the Commission and an order of the Commission permitting such plan to become effective. Such approval was to be withheld if the Commission found the plan (1) not fair and equitable, (2) not feasible, or (3) inconsistent with the purposes of the Act. The foregoing provisions were vigorously protested by the industry. Its members saw no reason why reorganizations of investment companies should be on a basis different from reorganizations of industrial companies. Alleged abuses in connection with reorganizations were no more frequent in cases of investment companies than other types of companies.

The compromise evidenced by the Investment Company Act seemed reasonably to meet the views of both Commission and industry. The provision for filing proxies and other material is designed to inform the Commission as to plans of reorganiza-

tions, but contains no grant of power. In respect of proxies so filed, the Commission derives its power under the proxy section of the Act. In discussing these provisions, representatives of the Commission expressed the belief that many companies would like the benefit of at least an advisory opinion from the Commission and consequently power was granted to render such opinion on request. It appears that already several companies have availed themselves of this. The provision permitting 25 per cent of any class of securities to call upon the Commission for an advisory opinion is not likely to be of much importance, as the time element will not generally permit this to function.

Representatives of the industry proposed to the Commission that, in lieu of power to pass upon all plans of reorganization, it be given authority in effect to intervene on behalf of stockholders by a proceeding in the federal court when it believed any plan to be grossly unfair. This provision in the opinion of the writer constitutes an interesting experiment. The arm of an administrative branch of the government is available to protect the rights of stockholders in an extreme case, but jurisdiction to determine the issue is vested in a court and not in the Commission. It must be remembered that under existing laws it is the courts to whom stockholders must look for protection and determination of their rights in connection with any reorganization. There seemed no reason why this jurisdiction, exercised for many years by the courts, should be shifted to an administrative agency. On the other hand, it seemed reasonable that the stockholder who might not have sufficient means to cope on equal terms with a management backed by corporate funds, should have the assistance of a governmental agency. From a practical point of view, the writer would expect that the mere existence of this power in the Commission would have a salutary effect.

PERIODIC REPORTS, ACCOUNTS, AND RECORDS; APPOINTMENT OF AUDITORS

Sections 30 and 31 deal with periodic reports, accounts, and records. Investment companies are required to file the same reports as are required of listed companies under the Securities Exchange Act. Copies of reports to stockholders must be filed with the Commission. Reports are required to be transmitted to

stockholders at least semi-annually and must contain such of the items definitely enumerated in the Act as the Commission may prescribe.⁹² These reports to stockholders may not be misleading in the light of reports filed with the Commission. This last somewhat curiously worded provision is a compromise giving to the Commission some jurisdiction over the form of reports to stockholders. As the Commission has fairly broad powers as to the form of reports filed with it, the necessity of having the reports to stockholders be at least reconcilable with the former accomplishes this.⁹³ It is further provided that financial statements contained both in reports filed with the Commission and in those transmitted to stockholders, if so required by the Commission, be accompanied by a certificate of independent public accountants. The scope of the audit of the independent accountant is prescribed in somewhat general terms and in particular there are specified the methods for verifying securities owned. Certain accounts and records are required to be maintained for such period as the Commission may prescribe and are to be subject to examination by the Commission. The Commission is also given authority to issue rules and regulations providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by investment companies. More drastic provisions in the original bill, giving the Commission broad powers over accounts and records and reports to stockholders, were eliminated.

The foregoing provisions of the Act are, in the opinion of the writer, of fundamental importance. The requirements for extensive disclosure in reports to the Commission and to stockholders,⁹⁴ together with the provisions making accounts and records of investment companies open to inspection by the Com-

92. The enumerated items are (1) a balance sheet; (2) a list of amounts and values of securities; (3) an income statement, itemized at least as to matters representing more than 5 per cent of total income or expenses; (4) a surplus statement, itemized at least in respect of matters representing more than 5 per cent of total charges or credits; (5) a statement of payments in certain specified categories to officers, directors, and affiliated persons; and (6) a statement of the aggregate dollar amounts of purchases and sales of securities.

93. Under the Securities Exchange Act the Commission, while prescribing the form of reports filed with it, has no jurisdiction over reports sent to stockholders.

94. Naturally, the requirements as to reporting to the Commission are much more far reaching than would be feasible in stockholders' reports.

mission, are very effective restraints on improper action. The prophylactic effect of publicity requirements is too generally recognized to need discussion here. Suffice it to say that even transactions honestly believed to have been entered into in good faith often look quite different in the broad glare of public scrutiny.

Section 32 of the Act in effect requires investment companies to appoint annually independent public accountants in the following manner: (1) such accountants are to be selected in the first instance by a majority of those members of the board of directors who are not officers or employees or investment advisers of such registered company; (2) such selection must be submitted for ratification or rejection at the next annual meeting of stockholders; and (3) the employment of such accountants must be conditioned upon the right of the company by vote of a majority of outstanding voting securities at any meeting called for such purpose to terminate the employment forthwith. If the selection of the directors is rejected, the stockholders may appoint auditors. It is further provided that the certificate or report of accountants shall be addressed both to the board of directors and to the security holders of the investment company.⁹⁵ All this is accomplished by provision that after one year from the effective date of the Act it shall be unlawful for any registered management company to file with the Commission any financial statement signed or certified by an independent public accountant unless such accountant has been appointed in the manner above indicated.⁹⁶

The evident purpose of these provisions is to insure that auditors are responsible to the security holders of the company as well as to the directors.⁹⁷ They represent a compromise between the views of the Commission, as expressed in the original bill and elsewhere, that auditors should be selected by stockholders, and the views of the industry that responsibility for audits lies with the board of directors under corporate law and that there-

95. Special provision is made with respect to common law trusts.

96. In similar manner it is provided that the comptroller or other principal accounting officer or employee of every management company must be elected, either by the holders of such company's voting securities or by the board of directors of the company.

97. Similarly, the purpose of the provision with respect to the comptroller or chief accounting officer is to make such person responsible to the directors rather than to some senior executive officer.

fore the auditors should be selected by them. It was of course not disputed that public accountants, no matter who selected them, had a responsibility to security holders and others as well as to the board of directors. Judge Healy, the member of the Commission in charge of the investment company investigation and the proposals for legislation, in his testimony before the Senate Committee stated his view that the practical effect of having auditors selected by stockholders was primarily one of emphasis and psychology.⁹⁸ It would seem that this objective is met by the provisions of the bill as enacted. Nevertheless, the Commission in its general attitude towards the selection of accountants still seems to hold to its original position that such selection should be made by stockholders.

FUNCTIONS OF THE SECURITIES AND EXCHANGE COMMISSION UNDER THE ACT

General powers of enforcement are given to the Securities and Exchange Commission more or less in line with powers held by it under other acts.⁹⁹ In some respects the enforcement powers contained in the original bill have been modified. Broadly speaking, however, the same powers of enforcement that originally seemed so alarming to the industry became unobjectionable when contained in the final bill with its modified substantive provisions. Of particular importance as an enforcement weapon are the provisions permitting the Commission to make such investigations as it may deem necessary to determine whether any person has violated or is about to violate any provision of the Act and permitting the Commission specifically to bring proceedings in the United States courts to enjoin any violation which may be threatened.

The Commission is authorized to bring proceedings in the United States courts alleging that any officer, director, member of an advisory board, investment adviser, depositor, or principal underwriter has been guilty of gross misconduct or gross abuse of trust in respect of a registered investment company, and upon

98. See Hearings before a Subcommittee of the Committee on Banking and Currency on S. 3580 (1940) 76th Cong., 3rd Sess., 305. Whatever the form, experience indicates that in normal cases it is to be expected that stockholders will vote in favor of the selection of such auditors as may be recommended by the management.

99. Sec. 42.

the establishment of such allegations the court is directed to enjoin any such person from acting in such capacity either permanently or for such period of time as it in its discretion shall deem appropriate.¹⁰⁰ This provision grew out of one in the original bill which made any gross misconduct or gross abuse of trust unlawful. The industry objected to it on the ground that such an indefinite standard should not be made the basis of a federal offense.

Other powers vested in the Commission, including the broad discretion to grant exemptions from specific prohibitions, have been referred to from time to time in the discussion of specific sections of the Act. In general, as has been seen, the Act prohibits with definiteness many types of transactions, giving to the Commission power to grant exceptions. These exceptions in almost all, if not all, cases may be either by general rule or regulations or upon order in specific cases. The most important and far reaching of these grants of power is that of Section 6(c) which permits the Commission conditionally or unconditionally to exempt any person, security, or transaction or any class or classes thereof, from any of the provisions of the Act. Without these exemptive powers and without a wise exercise of discretion thereunder, the Act would be unworkable, unduly restrictive, and would cause unnecessary hardships.

In the granting of such wide discretion, particularly in individual cases, it must be recognized that there is always the theoretical possibility of grave abuse of power by an unscrupulous agency through special treatment to favored persons. But this possibility was not even seriously considered by the industry. Respect for the integrity of the Securities and Exchange Commission as well as for most federal agencies is such that this particular evil is not a present threat. On the other hand, the industry did object to the broad delegations of the original bill under which matters of fundamental importance were left for formulation to the Commission, with little if any standards for guidance. It is true, as Judge Healy stated in his testimony before the Senate Committee,¹⁰¹ that Congress alone can legislate and the Commission can merely issue rules and regulations. But

100. Sec. 36.

101. See Hearings before a Subcommittee of the Committee on Banking and Currency on S. 3580 (1940) 76th Cong., 3rd Sess., 45.

it is small comfort to an individual that it is not legislation but only a rule or regulation that stands between him and a desired objective. The penalty for violation makes no distinction.

Viewed as a whole, it is the belief of the writer that the Commission has very extensive control over the investment company industry. Aside from the exercise of specific powers, the mere existence of such gives to the Commission a wide authority. Wisely and judiciously exercised, this influence of the Commission can be of great benefit to investment companies and their stockholders. It can be a factor of prime importance in molding the development of investment company practice. The experience of the few months in which the Act has been in operation already gives ample proof of this. It is becoming widespread practice to consult with the Commission as to matters over which it has no specific jurisdiction.

On the other hand it must not be overlooked that in any instance where an agency has such broad powers, its authority can be used improperly to force compliance in matters not within its jurisdiction. This possibility, always more likely on the part of subordinates, calls for constant vigilance on the part of the agency lest it more or less unconsciously drift into this very grave abuse. Furthermore there exists at times a temptation, in granting exemptions, to impose restrictions deemed wise by the agency but not warranted by the terms of the Act.

Fortunately cooperation under the Investment Company Act between the Commission and the industry is continuing. This is carried on primarily through the National Committee of Investment Companies, an informal association open to all members of the industry and containing as members a very substantial portion of existing investment companies. This Committee, through its executive director¹⁰² and counsel, is in constant touch with the staff of the Commission and is consulted by it on all matters of general interest to the industry. Rules and regulations are developed in conferences between the two groups and where questions arising in connection with specific cases appear to be of general interest, these matters are also generally discussed with representatives of the Committee. In connection

102. Mr. Paul Bartholet, the Executive Director, for many years an investment company officer, acted as technical adviser to the representatives of the industry in connection with the drafting of the Act.

with matters relating to the distribution of securities of open-end companies, cooperation with the Commission is largely through the National Association of Security Dealers, Inc.¹⁰³

CONCLUSION

There has been complaint on the part of some that the Act is unnecessarily long and complex. That it is long and complex is admitted, but whether unnecessarily so is another matter. It is true that the necessity for haste in its drafting is responsible for some imperfections and that with more time available faulty draftsmanship in certain instances would undoubtedly have been eliminated.¹⁰⁴ But in the main it is due to the fundamental theory on which the Act was drafted, namely, that prohibited acts be specifically enumerated subject to exceptions in the discretion of the Commission.

It would have been comparatively easy to draft a short act containing on the one hand very drastic and sweeping prohibitions and, on the other hand, setting up standards of practice in very general terms to be worked out case by case either by the Commission or the courts. For example, complete segregation from investment companies of investment bankers, dealers in securities, brokers, investment advisers, bank officers, and directors and directors of portfolio companies could have been effected in simple language. But the industry would have opposed this vigorously and the Commission had concluded that such segregation was not warranted. It therefore became necessary to formulate rather elaborate and perhaps complicated provisions to curtail, if not eliminate, the possibility of abuses which might arise from improper use of these relationships. Had the Act in general terms prohibited "unfair practices" and such, the drafting might have been simple and a great deal of ink saved, but the industry would have been left in complete uncertainty as to its rights and duties. Past experience has shown that this type of legislation is not workable as a means of regulating industry.¹⁰⁵

It was not intended that the Act should be a complete cure of

103. See page 331, *supra*.

104. The Act was written in substantially its present form between May 13 and May 31, 1940. It was expected at the time that Congress would adjourn in the middle or end of June.

105. Cf. Sherman Act (1890) 26 Stat. 209, c. 647, 15 U. S. C. A. secs. 1-7.

all possible evils in the investment company field. It seemed wiser to proceed cautiously and experimentally, attempting to prevent the main abuses which had been known to exist. In the light of experience, some amendments will undoubtedly be necessary. But in general it is the belief of the writer that the Act in its present form, because of specific prohibitions, because of its prophylactic effect, because of the intangible influence which the Commission is able to exercise, and because of the continuing cooperation between the Commission and the industry, will prove a satisfactory piece of legislation. Beyond that, it is the hope of many that if further regulation of business by the federal government becomes necessary, this example of mutual trust and cooperation between government and industry may set a useful precedent.