

# Investment Company Act of 1940

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# THE INVESTMENT COMPANY ACT OF 1940

RICHARD B. TOLINS

Certain security holding companies fall within the category of investment companies.<sup>1</sup> Investment companies have been variously defined<sup>2</sup> but for our purposes it need only be stated that they are associations, the legal structure of which will be discussed, in which the investing public pools its funds primarily for the purpose of investment in securities. The professed object of an investment trust is to enable a number of investors to pool their funds in order to reap the benefit of intelligent investment in a diversified portfolio.

After an analysis of the structure of investment companies, an attempt will be made herein to trace briefly something of their history and growth, showing their importance in the national economic picture, point out some of the existing evils and abuses, and discuss the Investment Company Act of 1940 in the light of these evils and abuses and of the Bill,<sup>3</sup> which, as amended, became the Act and took effect November 1, 1940.

For the purposes of preliminary discussion and analysis investment companies may be divided into four classifications:<sup>4</sup>

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<sup>1</sup>"The term 'investment trust' has been avoided in the definition and generally in the report because of its restricted meaning and misleading implications. The great majority of these organizations are not trusts even in form and those which are trusts in form are seldom true trusts, for almost invariably the trustee does not possess the rights and powers of a true trustee nor is he subject to the obligations and liabilities of such a trustee. The trustee has rather the status of custodian of the securities of these organizations, with some additional duties of a ministerial nature." *Investment Trusts and Investment Companies*, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, pursuant to § 30 of the Public Utility Holding Co. Act of 1935, Part I, Ch. II, p. 19, n. 10 (hereinafter called the REPORT).

<sup>2</sup>"A securities company was deemed to be an investment company if more than one-half its assets, other than cash and U. S. Government securities, consisted of securities other than U. S. Government securities and securities of subsidiary companies which were not investment companies." REPORT, p. 19. Section 3 of the Wagner Bill for the regulation of investment companies (S. 3580) contains a substantially similar definition.

The N. Y. Stock Exchange's "Special Requirements for Listing Investment Trust Securities" defines investment trusts as "such companies as are engaged primarily in the business of investing in the securities of other corporations for the purpose of revenue or profit and not in general for the purpose of exercising control." This is a very inaccurate definition. As will be shown, in many cases the purpose *was* the exercise of control.

The Report of the Senate Committee on Banking and Currency on Stock Exchange Practices defines an investment trust as "a company, incorporated or unincorporated, organized to acquire and hold securities in other companies for investment purposes." SEN. REP. NO. 1455, 73d Cong., 2d Sess. (1934) 333.

No text book definitions are submitted since most contain the professed aims of these organizations rather than the characteristics thereof. See ROBINSON, INVESTMENT TRUST ORGANIZATION AND MANAGEMENT (1929).

<sup>3</sup>S. 3580. A Bill to Provide for the Registration and Regulation of Investment Companies and Investment Advisers, and for Other Purposes, introduced by Senator Wagner and known as the Wagner-Lea Bill.

<sup>4</sup>REPORT, Part I, Ch. II, Sec. III, p. 22 includes "common or commingled" trust funds

- (1) Management Investment Companies,
- (2) Fixed or Semi-Fixed Trusts,
- (3) Installment Investment Plans, and
- (4) Companies Issuing Face Amount Certificates.

Management investment companies differ from the other types in that no restrictions, or only limited restrictions, are imposed with respect to nature, type, and amount of investments which may be made. The usual legal structure is the organization of an investment corporation under the general corporation law of the state.<sup>5</sup> The rights and obligations of security holders of these corporate investment companies correspond to those of the holders of similar types of securities of ordinary corporations.<sup>6</sup>

A number of management investment companies are in the form of the Massachusetts type trusts, that is, the "sponsors" are both settlors and trustees and the trust indenture names the persons who contribute to the fund as the *cestuis que trust* or beneficiaries. The indenture usually provides for the self-perpetuation of the trustees and places varying degrees of management and control in their hands. The contributors to the fund are not, of course, parties to the agreement but by participating they become the beneficiaries thereof and are bound by its terms and conditions. Whether such a structure creates a true trust or merely a limited partnership depends on tests which the courts have established.<sup>7</sup> In some instances the courts have even construed these organizations as being, in effect, corporations not validly organized under state law,<sup>8</sup> and in others where there is a statutory or constitutional provision defining "corporations" as including, for the particular purpose involved, "all associations and joint stock companies having powers and privileges not possessed by individuals and partners," the courts have treated them as corporations.<sup>9</sup>

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as a fifth classification. Since participation therein is not available to the general public this group is not of interest herein.

<sup>5</sup>Note that they are not organized under any special act as banking and insurance companies are.

<sup>6</sup>Common stockholders possess only the right, on dissolution of the corporation, to participate in the corporate assets after all other claims have been satisfied. STEVENS, CORPORATIONS (1938) § 201.

Preferred stockholders generally have a preference over common with respect to payment of dividends and distribution of assets on dissolution. *Id.* at 409 and 420.

Debenture holders are usually unsecured creditors of the corporation and their claims have priority over both common and preferred stockholders. *Id.* at § 92.

Secured bondholders have a lien on specific assets of the corporation and are secured creditors. *Id.* at § 91.

<sup>7</sup>If the trustees are to act as principals and are to be free from the control of the certificate holders, a trust is created; but if the so-called trustees are merely to be managing agents the agreement constitutes a partnership. 9 ENCYC. SOC. SCI. (1937) 189; 47 C. J. 646, § 20 (2); *Thompson v. Schmitt*, 115 Tex. 53, 274 S. W. 554 (1925). See *supra* note 1.

<sup>8</sup>*Cf. Weber Engine Co. v. Alter*, 120 Kan. 557, 245 Pac. 143 (1926).

<sup>9</sup>*Home Lumber Co. v. State Charter Bd.*, 107 Kan. 153, 190 Pac. 601, noted (1921)

The management investment "trust" may have more than one class of capital securities and bonds and debentures with interests similar to those of corporate security holders.<sup>10</sup> However, the shareholders are rarely given the right to vote.

A very few management investment companies are joint stock companies and an equally small number consist of an agency relationship wherein the individual contributors to the fund confer substantially a power of attorney on the management to act as agent in the investment of the moneys contributed. These have no distinct legal entity as investment companies but constitute in essence combinations of distinct individual interests.<sup>11</sup>

There are other possible subdivisions and classifications of management investment companies into types of investment restrictions, amount of control over affairs of portfolio corporations, closed-end and open-end management investment companies,<sup>12</sup> leverage and non-leverage management investment companies<sup>13</sup> and others, but only the last two are of any importance herein and they lend themselves to the discussion without further analysis.

A fixed investment trust is created under the terms of a trust indenture or agreement entered into between a sponsor corporation, usually designated as the "depositor," a bank or trust company, usually designated the "trustee," and the persons who contribute the funds of the trust, known as the "certificate holders," and who are the beneficial owners of the trust property. Management is reduced to a minimum because the trust indenture, which is the controlling instrument, usually specifies not only the securities in which

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6 CORNELL L. Q. 348 (business trust held subject to Blue Sky law); STEVENS, CORPORATIONS (1938) 40.

<sup>10</sup>*Supra* note 6.

<sup>11</sup>STEVENS, CORPORATIONS (1938) chs. I and II.

<sup>12</sup>"Most management investment companies proper and all investment holding companies are of the 'closed-end' type, the type in which no provision is made for redemption or purchase of shares by the company at approximately their net asset value on demand of the shareholder." REPORT, Part I, Ch. II, Sec. III, p. 26.

<sup>13</sup>"A leverage company has one or more issues of bonds, debentures, preferred stocks, or other securities outstanding in addition to common stock. A non-leverage company has only one class of security outstanding, usually common stock." REPORT, p. 28.

It is relevant to note that in times of rising security prices the increase in the asset value applicable to the outstanding junior security issues is proportionately greater than the increase in the total value of all the assets of the investment company, reflecting what is termed the "leverage" of junior securities. This results from the fact that the benefit of an increase in income or asset which goes to the senior security holders is limited to a fixed amount and the balance goes to the junior security holders. Conversely, in times of declining security prices, the decrease in asset value of the junior securities in a leverage company is proportionately greater than the decrease in its total assets, since the junior securities bear all decrease in income and assets before the senior securities.

As a result of this and by the leverage of the common stock the sponsors and directors of a certain investment company were able, in four years, to earn for themselves a profit of 450%, whereas the investors, the public, only profited about 28%. See REPORT, Part III, Ch. I, Sec. II, A, 2 (b), p. 12.

the fund may be invested but also the relative proportion of each security which may be purchased.

The great majority of fixed trusts are "unit type" and are so termed since the depositor placed with the trustee, under the terms of the trust agreement, a specified quantity or unit of securities which went to make up the underlying property. Since each unit deposited had to conform to any modification of prior deposited units, all units were identically composed. The trustee issued a set number of trust certificates against each unit to the depositor who, as sponsor company, in turn sold the certificates to the public.

As the name might suggest, the installment investment plans are essentially devices for the sale of investment trust or investment company securities on a periodic or installment payment basis. Periodic payment certificates, which constitute participations in the plan, are the securities which are directly sold to the public. These certificates in turn represent an interest in underlying securities which are shares of another specified fixed or management investment trust or company.<sup>14</sup> The legal structure is similar to that in the fixed trust with the certificates which constitute participation in the plan being issued pursuant to a trust agreement which prescribes the terms of the plan, its method of operation and the underlying securities, defines the rights and obligations of the sponsor corporation, and terms the banking institution "trustee," and the purchasers of certificates "certificate holders."

Face amount certificates are contracts between the corporation which issues them and the purchaser, whereby in consideration of the payment of certain specified sums the corporation agrees to pay to the purchaser, at maturity, the face amount of the certificate, or to pay prior to the maturity, upon demand and surrender of the certificate, its attained surrender value.

### I. HISTORY AND GROWTH OF INVESTMENT COMPANIES

Up to the year 1921 there were comparatively few investment companies. During 1921-1926 the idea was definitely adopted by some of the larger financial institutions of the country and the movement began to grow in size and importance. Statistics show that the movement attained its peak in the four years after 1926.<sup>15</sup> Savings banks, life insurance companies, trust funds, security affiliates, fire insurance companies, and particularly holding companies

<sup>14</sup>An incident of this representation is the double sales load placed on the installment investor.

<sup>15</sup>Prior to 1921 — New cos. organized — 40  
 1921-1926 — " " " — 139  
 1926-1930 — " " " — c. 800  
 1930-1936 — " " " — c. 200  
 REPORT, Part I, Ch. III, note 1.

were influential in fostering the rapidly growing infant.<sup>16</sup> The economic conditions of the period were conducive to new enterprises<sup>17</sup> and the investing public were given powerful stimuli by the sponsor companies.

The actual selling arguments were many and varied. They are worth noting here to show the claims made in attempts to further this type of investment. Growing prosperity and the investment company as a means to share therein were stressed—but no mention was made of possible loss. The safety of the investment was constantly repeated and linked up in various attractive posters and “catch-expressions” with the growth of the United States. Safety, the investor was told, was ensured by the diversification of the security holdings of the investment companies (the law of averages presumably making the plan infallible), by the scientific and expert management and like investment ability of the management.<sup>18</sup> Of course the invalidity of these claims is established by the fact that over a ten year period there was little, if any, difference between the performance of these investment companies and that of the common stock index.<sup>19</sup> The motivating forces behind this barrage of sales publicity were the numerous sources of profit and patronage to the sponsor company,<sup>20</sup> the opportunity for the sponsor company to use the investment company as a means of acquiring or retaining control of a particular industrial company and the fact that the large resources of investment companies, which were usually under the domination of the sponsor company, served to enhance the latter’s financing capacities. On the other hand it is only fair to point out that the funds so invested must have had a vitalizing effect on industry in general although it is impossible to determine the extent to which the investment companies actually supplied the needs of industry during the period.

Major factors in this expansion were leverage, market trading and market premiums. Yearly sales of these issues increased from almost \$400,000,000 in 1927 to over \$3,000,000,000 in 1929, total assets increased to over \$8,000,-

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<sup>16</sup>REPORT, Sec. II, B.

<sup>17</sup>Indices show a steady increase in industrial activity; national income grew from approximately \$58,000,000,000 in 1921 to over \$79,000,000,000 in 1926; prices of common stocks rose accordingly. See INDEX OF THE STANDARD STATISTICS CO., INC., STANDARD TRADE & SECURITIES, vol. 88, no. 9, sec. 7, April 29, 1938, p. D-67.

<sup>18</sup>Some of the larger companies even formed economic councils, advisory boards and research departments. However, these were short lived.

<sup>19</sup>H. R. Doc. No. 70, 76th Cong., 1st Sess. (1939), Pt. Two, Appendix J, pp. 904-6, and Supp. V, pp. 933 *et seq.*

<sup>20</sup>REPORT, Part I, Ch. III, A (2), p. 62 lists “special management stocks, options and other bonus arrangements, underwriting fees and selling commissions, brokerage commissions, benefits from direct dealings with the trust, management fees, custodians fees, salaries, legal fees, accounting fees, and service charges” as only some of the sources of possible profit. Certain of these are discussed later under the heading of Abuses and Evils, *infra*.

000,000 and investment companies were literally being formed at the rate of almost one each business day.<sup>21</sup> There was extensive trading activity in investment company securities on the stock exchanges and over the counter,<sup>22</sup> and it is at least suspected that these were operations designed merely to drive up the market price.<sup>23</sup> By 1929 the securities of investment companies enjoyed such popularity that they were being sold at a premium above their asset values. Even the securities of newly organized and untested companies sold at large premiums, some on a "when-issued" basis, before the actual issuance of the securities. These premiums were made possible by leverage,<sup>24</sup> extensive trading, rising market prices, public speculative fever, misleading accounting, excessive valuation, pyramided systems and combinations thereof.

After 1930, and the stock market collapse, investment companies suffered most as a result of the very factors which aided their previous expansion, namely leverage, market trading and market premiums.<sup>25</sup> This period was marked by the disappearance of a large number of investment companies as a result of bankruptcies, receiverships, dissolutions and to a certain extent mergers and consolidations. The organization of new companies declined sharply.

The decline in the market also afforded sponsors, managers, officers, directors, and other controlling interests an opportunity to obtain great personal profit, resulting in substantial losses to the investment companies and thus the investing public. This was accomplished through a variety of methods including repurchase of shares,<sup>26</sup> transactions induced by conflicting interests,<sup>27</sup> etc. Various small groups were able, with no personal investment, to obtain control of a number of companies whose total assets were valued at millions of dollars.<sup>28</sup> Also as a result of the market decline investment companies' securities began to sell at substantial discounts and this in time resulted in popular disfavor of investment company management. To circumvent this

<sup>21</sup>REPORT, Part III, Ch. I, Sec. II, pp. 2, 3 and 4. Also see H. R. Doc. No. 707, 75th Cong., 3d Sess. (1939), Pt. One, Ch. III, Table I, pp. 57, 30-32, 35 and 36; H. R. Doc. No. 70, 76th Cong., 1st Sess (1939), Pt. Two, Ch. II, Table 16, p. III.

<sup>22</sup>H. R. Doc. No. 70, 76th Cong., 1st Sess (1939), Pt. Two, Ch. IV, pp. 299 *et seq.*

<sup>23</sup>REPORT, Part III, Ch. I, p. 14.

<sup>24</sup>H. R. Doc. No. 70, 76th Cong., 1st Sess. (1939), Pt. Two, Ch. IV, pp. 321-324. Investors in leverage companies were particularly hard hit. Whereas the average dollar invested in non-leverage companies depreciated to about 21 cents in market price by June, 1932, the average dollar invested in a leverage company depreciated to about 2 cents in the same time. See *supra* note 13.

<sup>25</sup>*Supra* note 13.

<sup>26</sup>REPORT, Part III, Ch. I, pp. 20 and 21.

<sup>27</sup>*Id.* at 22.

<sup>28</sup>See *infra* pages 84 *et seq.* Also see REPORT, Part III, Ch. I, p. 26; and statement of A. A. Cook, *Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess. (1940), Part I, pp. 59 et seq.* (hereinafter called *Hearings before Subcommittee*).

disfavor sponsor companies organized the fixed or unit type trusts minimizing management and emphasizing that the shares would not sell at a discount since the shareholder could redeem his certificates at about asset value. These had a brief period of popularity, but the restrictions on management and the underlying securities hampered the sponsor companies, and eventually most of them were turned into management investment trusts, usually of the open-end type.<sup>29</sup>

Although there has been a considerable shrinkage since 1929, investment companies are still an important factor in our national economy. It has been estimated that one out of every ten investors in the country is a participant in an investment trust or an investment company.<sup>30</sup> It is significant that in spite of the large percentage of the investing public involved (approximately 1,500,000 individuals) control of each company has been vested and perpetuated in a very small group.<sup>31</sup>

## II. ABUSES AND EVILS

Before discussing the abuses which have become manifest in the operation of the great majority of investment trusts it should be stated that there can be no objection to the inherent nature of investment companies or investment trusts as such. Properly regulated so as to secure the investing public and the public at large from the defects which will be pointed out, the investment trust is a desirable means of investment for the general public. There is no question that the ordinary investor has neither the time, nor the finances, and probably not the ability, to become an expert on various types of stocks and securities. Nor has he alone the finances to invest in a sufficient diversification of stocks to secure for himself such a minimization of risk as is offered by the investment company. It is submitted that with an efficient management whose primary interest is the satisfaction of its fiduciary duty toward the certificate holders, an investment company can be of valuable service to the community; but the fiduciary capacity of the trustee or manager must be stressed. It need hardly be mentioned that many investment companies were conducted by independent management, and fully disclosed their portfolio,

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<sup>29</sup>*Hearings before Subcommittee*, p. 227; SUPPLEMENTAL REPORT OF S.E.C. ON FIXED AND SEMI-FIXED INVESTMENT TRUSTS (1940), pp. 214 and 215.

<sup>30</sup>H. R. Doc. No. 70, 76th Cong., 1st Sess. (1939), Pt. Two, Ch. V, pp. 369-371.

<sup>31</sup>*Id.* at 398-399. ". . . this control is acquired or retained in the investment company field either through strategic stock ownership or other control devices such as management contracts, voting trusts, special classes of voting stocks, common law trusteeships or business trusts. Furthermore, small stockholders are unable effectively to exercise their combined voting power because of the inadequacies of voting machinery, the costliness of conducting a campaign against the existing management, and the smallness of the individual stakes." REPORT, Part III, Ch. I, Sec. III, p. 33.



genuinely attempting sound investment of the public's money;<sup>32</sup> but this has not been the history of the majority of investment companies.

The major abuses which have caused these companies to fall into disrepute may be grouped as follows:

- (1) Removal of funds from control of those who supply them,
- (2) Conflicting interests of management,
- (3) Pyramiding,
- (4) Excessive management charges and hidden fees, and
- (5) Management's use of control.

It is important to remember that these abuses are interlocking and usually exist concurrently; thus, during the discussion of any one, each of the others should be constantly kept in mind.

*Removal of funds from control of those who supply them*

The devices employed by promoters and managers of investment companies to obtain absolute control of the funds range from the very simple to the very complex.<sup>33</sup> Probably the simplest means employed was the issuance of the following capital:<sup>34</sup>

Debentures .....	\$307,000
First Preferred .....	625,000
Class A Stock, 35,000 shs. ....	255,000
Class B Stock, 25,000 shs. ....	250,000
	\$1,437,000
Total Capital	

Since the voting power was entirely lodged in the Class B stock the organizers could, with an investment of only \$250,000, completely control a fund of more than five times that amount.

Nor need the organizers actually put up that amount of money. It is obvious that control could be gained by only buying a much smaller block of the voting stock; but the following illustration<sup>35</sup> shows that control may be obtained with absolutely no investment at all. Issues were:

1,900,000 shs. non-voting stock @ \$27 .....	\$51,300,000
100,000 shs. voting stock @ \$25 .....	2,500,000
	\$53,800,000
Total	

<sup>32</sup>The REPORT fails in its duty completely to report the industry by its failure to report this fact more clearly.

<sup>33</sup>Although actual capital structures of various companies will be used for illustration, it should not be inferred that the management of those particular companies are or were practising any of the abuses.

<sup>34</sup>The Colonial Bond and Share Company, organized in Delaware.

<sup>35</sup>FLYNN, INVESTMENT TRUSTS GONE WRONG (1930) 38. Also see REPORT, Part III, Ch. II, Sec. IV, pp. 115 *et seq.*

"As the voting stock was issued to itself, it looks as if the bank got control of a \$50,000,000 fund for \$2,500,000. But the statement, issued before any investments were made, did not give \$53,800,000 as the sum obtained from the sale of the two issues. It read as follows:

1,900,000 shs. non-voting stock . . . . .	\$47,500,000
100,000 shs. voting stock @ \$25 . . . . .	2,500,000
Total	<u>\$50,000,000</u>

"The apparent disappearance of \$3,800,000 may be naturally explained."<sup>36</sup> It is explained that the \$3,800,000 was organization expense, that this was enough to pay for all the voting stock and leave a balance of \$1,300,000, and that in this manner a bank could get control of a \$50,000,000 fund "without putting up a cent—and get it in perpetuity."

Nor was it uncommon for investment companies to be organized with the bankers taking all or one-half of the common stock as payment for organizing the trust,<sup>37</sup> thus obtaining control with no investment.

The limited scope of this article precludes setting forth the various other, and more complicated, devices of obtaining control of the fund but they have already been fully treated elsewhere.<sup>38</sup> The illustrations are sufficient to show that the managers of these funds are obtaining permanent ownership and complete control thereof.<sup>39</sup>

It is true that the very nature of the investment company calls for control of the fund for the purpose of *management* by the managers. They must have full exercise of their discretion to handle the fund to the best advantage, but it must be remembered that in the exercise of a fiduciary duty the advantage should be that of the fund and the investors—not that of the organizer or manager. The very nature of the control obtained in most companies shows that it was not obtained for the purpose of management, and the most casual glance at the uses made of this control proves the point conclusively.

Specifically, the certificate holders or participants in the trust should be assured of the power to dismiss an incompetent management and this concentration of control has deprived them of that power.

<sup>36</sup>FLYNN, *loc. cit. supra* note 35.

<sup>37</sup>For example, the Kidder, Peabody & Company trusts, known as Kidder Participation Nos. 1, 2 and 3.

<sup>38</sup>REPORT, Part III, Ch. II, Secs. I-XI, pp. 115-778; FLYNN, *op. cit. supra* note 35, ch. III.

<sup>39</sup>"A comparatively small number of stockholders has held a substantial portion of the outstanding voting shares of investment trusts and investment companies. This concentration of ownership, together with the wide diffusion of the balance of the stock, has perpetuated the control of dominant personalities and has constituted a factor contributing to the development and continuance of abuses." REPORT, Part III, Ch. I, Sec. III, B, p. 32.

*Conflicting interests of management*

The sponsors, or organizers, of investment companies and investment trusts usually retained management in their own hands and constituted a group of "insiders" who had obtained control of the fund. This undoubtedly was a contributing factor in the losses sustained<sup>40</sup> since in many instances unsecured loans, the principals of which were lost, were made to these "insiders," and their shares were repurchased at a profit to them but at the expense of the public shareholders.

The majority of the sponsors are banking and brokerage houses, and again management and control is entirely in their hands. Reduced to its simplest terms, this means that as bankers or brokers they have a portfolio of stocks to sell and as managers of the fund they have money with which to buy stocks. We need not assume that investment companies are formed solely, or even mainly, for the purpose of creating a perpetual market for their own securities, but, whatever the purpose, that is certainly the result.

In view of the fiduciary relationship existing between management and the shareholders, managers have a clear duty not to deal with themselves as principals,<sup>41</sup> at least not to the detriment of the fund.<sup>42</sup> However, there is no question that the great majority "have not hesitated to sell their own stock issues to their trusts"<sup>43</sup> and that the trusts have suffered substantial losses thereby.<sup>44</sup>

If a distinction as to management is drawn between the person of the manager and the board of directors, conflicting interests are still a problem since the majority of the directors serve two masters. The boards have been composed either of persons affiliated with the sponsor or persons affiliated with the companies in whose securities the fund has been invested. Thus interlocking directorates are the usual situation.

An instance will illustrate the result. The officers and directors of a sponsor bank were appointed officers and directors of the investment company. As usual the investment company had a substantial block of the bank stock, but the bank was in difficulty and its stock was declining. To whom did these directors owe the primary duty? As "insiders" they knew how great was the difficulty of the bank and thus their duty as directors of the investment company was to sell the bank stock. However, they were also directors of

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<sup>40</sup>Hearings before Subcommittee, pp. 207 *et seq.*

<sup>41</sup>At least one company recognized this point and its trust indenture prohibited such self-dealing. Public Examination, Investment Trust Fund A, p. 11486.

<sup>42</sup>STEVENS, CORPORATIONS (1938) § 154. See cases cited *infra* note 64.

<sup>43</sup>FLYNN, *op. cit. supra* note 35, at 64.

<sup>44</sup>*Id.* at 64 and 65. That the common law remedies for these evils are ineffectual is shown *infra* page 92.

the bank and they knew that liquidation of the investment company's bank stock would accentuate the bank's difficulty. In this case they held the stock and the investing public suffered a loss of \$2,000,000.<sup>45</sup>

There is absolutely no necessity for this situation. No one can deny the existence and availability of large numbers of capable, disinterested and independent persons who can take over the management of these investment companies. Then, too, there would be room for fair representation of the investing public on the board of directors.

### *Pyramiding*

The two classic examples of pyramiding are The American Founders Company<sup>46</sup> and the Goldman Sachs Trading Corporation,<sup>47</sup> but there are many others equally complicated.

Goldman Sachs and Company, members of the New York Stock Exchange, were the sponsors of Goldman Sachs Trading Corporation, an investment company incorporated in Delaware in December, 1928. One million shares, all common stock, all with the same voting power, were issued as follows:

100,000 shs. to Goldman Sachs @ \$100 .....	\$10,000,000
900,000 shs. to public @ \$104 .....	93,600,000
Total	<u>\$103,600,000</u>

Of this amount, \$100,000,000 was the capitalization of the investment company and the other \$3,600,000 went to the sponsors as fees for organization—a rather large but not unusual profit.

By September, 1929, the Goldman Sachs Trading Corporation had raised over \$326,000,000. By 1932 they had \$33,000,000 left, a loss of almost 90%. Although a good part of this loss was attributable to the stock market decline, it is equally true that a part thereof was attributable to the unnecessary size of the structure set up.<sup>48</sup> This structure, the complexity of which defies complete explanation or discussion, may best be explained by taking a small part thereof out of the complete picture.

The Goldman Sachs Trading Corporation branched out in three main directions, namely (1) The Shenandoah Corporation, (2) Pacific American Associates, Incorporated and (3) certain insurance, bank and security affiliates which were purchased in 1929 and may be grouped together. Each of these three in turn branched into an amazing number of other companies.<sup>49</sup>

<sup>45</sup>See *Hearings before Subcommittee*, p. 221, for names, amounts, etc.

<sup>46</sup>See FLYNN, *op. cit. supra* note 35, at 43 *et seq.*; *Hearings before Subcommittee*, pp. 93 *et seq.*

<sup>47</sup>See FLYNN, *op. cit. supra* note 35, at 78-91; *Hearings before Subcommittee*, pp. 229 *et seq.*

<sup>48</sup>*Ibid.*

<sup>49</sup>*Hearings before Subcommittee*, chart entitled "The Goldman Sachs Trading Corporation," facing p. 229.

The Shenandoah Corporation, before breaking down into these smaller branches, had two main branches, one of which we shall examine closely as indicative of its other branch and of the other two major branches of the original investment company, the Goldman Sachs Trading Corporation.

Of the original \$100,000,000 raised by the Goldman Sachs Trading Corporation \$10,379,900 was invested in Central States Electric Corporation, another investment company. Central States Electric and Goldman Sachs Corporation then formed the Shenandoah Corporation, again an investment company, with an original total capitalization of \$62,500,000. Each of the two organizing companies, by an exchange of stock, retained 40% of the issued stock. The stock in their own companies which was used as payment was valued at \$52,000,000 and in return they received 4,000,000 shares of Shenandoah stock. Thus they paid \$12.50 per share, whereas the stock which was sold to the public was sold for \$17.50 per share.

The Shenandoah Corporation then used the money so raised to organize another company, the Blue Ridge Corporation, still another investment company, which issued 7,250,000 shares of common stock. The public bought 1,000,000 shares at \$20 and the Shenandoah Corporation bought the remaining 6,250,000 at \$10. The \$62,500,000 was raised by selling Shenandoah preferred stock to the Goldman Sachs Trading Corporation.

To this point almost \$170,000,000 of the public's money had been raised and very little of that amount had been invested productively. Most of it had been used to create new wells for tapping the public's resources. It had been at least suggested that the purpose of this expansion of the structure was not at any time the advancement of the interests of the investment fund, but that the purpose was the use of the public's funds "essentially to help Goldman Sachs and Company's banking business."<sup>50</sup>

To continue with the Blue Ridge Corporation, some of its funds were invested productively, some were invested in other finance and investment companies such as the Central States Electric Corporation (which owns 40% of the common stock of the Shenandoah Corporation which, in turn, owns over 86% of the Blue Ridge Corporation common stock), the North American Company, and the American Cities Power and Light Company. Any one of these would again invest in a number of companies, sometimes obtaining control, sometimes merely in a small block of stock, and eventually the bottom of the pyramid would be reached.

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<sup>50</sup>See *supra* note 47. Mr. Schenker, Chief Counsel, S.E.C., Investment Trust Study, read into the record an extract from a letter written to the Goldman Sachs Trading Corp. by an analyst describing investment in the Greyhound Corp. as highly speculative but stating that it would probably eventually prove of value to Goldman Sachs and Company, *the bankers*. The investment was made.

Now presume that one of these industrial companies declared a dividend. Before that dividend reached the certificate holder in the Goldman Sachs Trading Corporation a charge for management would be deducted by each of the investment companies along the line, in this case four, and the Goldman Sachs Corporation would retain 20% of whatever reached it, and the balance, if any, would be handed over to the certificate holder.

It cannot be too strongly urged that there is absolutely no need nor useful purpose for this pyramiding. It serves neither the public nor industry in general. There is no sound financial or economic reason for it, and it combines all of the evils which are being discussed. Any person or group of persons, after forming an investment company, should not be permitted to form another until they have entirely disassociated themselves from the first, or until a number of years have elapsed<sup>51</sup> so that this pyramiding will be completely impossible.<sup>52</sup>

#### *Excessive management charges and hidden fees*

Management consists of acting as custodian of the fund and providing expert advice as to what securities to buy and the best time for purchase or sale. Outside the field of investment companies this is rapidly becoming a standardized service which a great many banks and trust companies offer with a charge of  $\frac{1}{2}$  of 1% a year based on the actual market value of the investments.<sup>53</sup> Computed over a period of six years the cost of managing 48 British investment trusts averaged 41/100ths of 1%.<sup>54</sup> This would seem to be a reasonable charge. However, the investment companies in this country which have been controlled by the sponsor banking companies have retained those bankers at rates varying from  $\frac{1}{8}$  of 1% quarterly of gross assets at market value to 20% of net income.<sup>55</sup> It is submitted that in any event the great majority of these charges are excessive and, in the light of what has

<sup>51</sup>Within one year, six investment companies were organized under the control, directly or indirectly, of the Goldman Sachs firm.

<sup>52</sup>FLYNN, *INVESTMENT TRUSTS GONE WRONG* (1930) ch. IX, is an interesting expression of opinion as to the result of this trend unless arrested.

<sup>53</sup>There are also opening and withdrawal charges of 1% each.

<sup>54</sup>FLYNN, *op. cit. supra* note 52, at 94.

<sup>55</sup>Investment Trust Fund A paid its sponsor, Investment Managers Company  $\frac{1}{8}$  of 1% quarterly of gross assets at market value, or slightly more than  $\frac{1}{2}$  of 1% a year. For the year 1926 they paid approximately \$49,000 [Reply to the Commission's questionnaire for Investment Trust Fund A, pt. 1, Exhibits B and C (1)]. Although slightly high, this would certainly seem adequate to meet the expenses of management and provide at least a reasonable profit. Other sponsor-managers received much higher percentages:

First American Corporation paid First American Management Corporation  $\frac{1}{8}$  of 1% quarterly plus 10% of the income.

Lehman Corporation pays Lehman Bros. 12 $\frac{1}{2}$ % of net earnings for management.

Goldman Sachs Trading Corporation pays Goldman Sachs and Company 20% of net income for management.

been set out herein as to the services rendered therefor, they are exorbitant. There is no reason why investment companies should not buy disinterested expert advice for a very small fraction of what they are now paying. There is no question as to its availability.

However, these specified management fees are not, in many cases, the only ones. There are hidden fees which are frequently as large. As has been pointed out,<sup>56</sup> sponsors and managers can, with only a small, and in some cases no, investment, obtain, by the leverage of junior securities, or any of various other devices, a much greater percentage of the earnings and profits than the investor.

Another method<sup>57</sup> is to make no provision for compensation to the managers, and thus on the surface to make investment in the company appear very favorable. However, there is usually a provision that at any time within a specified number of years the organizers may subscribe to common stock at a set figure up to a set number of shares. If the liquidating value of the common stock goes above the set price, as it usually does, then the organizers may take advantage of this special concealed profit. These are called purchase warrants and seem particularly inequitable since it is only after the fund has become successful and the investor is about to get some return that management swoops down and confiscates a large percentage of the profits.

#### *Management's use of control*

We are concerned herein with the broader aspects of the concentration of so much power. For example the Pacific American Associates Incorporated, through the American Company, owned the American Trust Company with its 96 branches in the San Francisco district. These banks owned about a half-billion dollars in assets. The Financial and Industrial Securities Corporation controlled the Manufacturer's Trust Company in New York, with 45 branches and about a half-billion dollars in assets. Pacific American Associates Incorporated was taken over 100% by Goldman Sachs Trading Corporation and the Financial and Industrial Securities Corporation was acquired and dissolved by the same investment company in 1929. Thus Goldman Sachs and Company, through Goldman Sachs Trading Corporation, controlled these two widely separated, enormous banking institutions with assets of almost a billion dollars.<sup>58</sup>

It is absolutely no reflection on the ability, honesty, integrity or responsibility of a banking house to state that no house, no matter how responsible or able, should be permitted such control and power.

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<sup>56</sup>See *supra* note 13.

<sup>57</sup>Organization of the Blue Ridge Corporation, *supra* pages 88 and 89.

<sup>58</sup>See *supra* note 49.

It has been almost universally admitted that managements of investment companies use their control thereof for the advantage of the investment banking or brokerage houses with which such managements are affiliated.<sup>59</sup>

The uses made of the complete control exercised by management are perhaps even better illustrated by the statement of Alfred A. Cook, trustee for the Continental Securities Corporation, appearing as a witness before a Subcommittee of the Senate Committee on Banking and Finance.<sup>60</sup> His testimony also indicated the necessity for the correction of the first listed abuse, namely the complete control by the managers. Mr. Cook pointed out that the portfolio of the Continental Securities Corporation was reduced in five months from \$3,300,000 to approximately \$50,000, without any substantial decline in the market, merely because the original management sold out to a new management and agreed that the then directors would resign and that new directors, chosen by the new management, would be rotated into office. The new management was as unsound as the new directors were uninitiate; securities disappeared from the portfolio, and the public was not apprised of the facts until much too late.<sup>61</sup>

There should be some safeguard against the sale of control and the election of a new board of directors without any notification whatsoever to the certificate holders. Even with notice, control is not properly the subject of a sale.

Other minor abuses have been the actual misrepresentations made by the sponsors and the secrecy which cloaks all the actions of the managers, sponsors and directors. These have to a great extent already been remedied through the authorization by Congress of investigation by the Securities and Exchange Commission and the exhaustive work that has been done in the field by that Commission. Further, in the light of the Securities and Exchange Acts and the Public Utilities Holding Company Act of 1935,<sup>62</sup> it would seem certain that the requirement of registration of the investment trusts and investment companies contained in the Act will obviate the possibility of misrepresentation or secrecy.

As has already been pointed out elsewhere<sup>63</sup> there are available to the investing public certain common law remedies for some of these abuses. Others are *damnum absque injuria*. Thus, it is well established that a fiduciary may not profit at the expense of the object of his duty and therefore

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<sup>59</sup>FOWLER, AMERICAN INVESTMENT TRUSTS (1928) 28; Harman, *The Investment Trust* (1929 June Supp.) 85 SCRIBNERS 56; Curtis, *Mine Own Usury* (1930) 131 NATION 93; FLYNN, INVESTMENT TRUSTS GONE WRONG (1930) 33 *et seq.* See *supra* notes 47 and 50.

<sup>60</sup>Hearings before Subcommittee, *supra* note 28.

<sup>61</sup>Criminal prosecutions of the new, and a civil action against the old management were subsequently commenced.

<sup>62</sup>48 STAT. 881, 15 U. S. C. A. § 78 (1934); 49 STAT. 838, 15 U. S. C. A. § 79 (1935).

<sup>63</sup>See Legis. (1930) 44 HARV. L. REV. 117, 118.



the share or certificate holders can vitiate the contract and compel the surrender of profits if the management was interested adversely to the trust;<sup>64</sup> that the excess over the fair value of services can be recovered if exorbitant salaries are drawn;<sup>65</sup> and that, if the management obtains shares in the trust at a nominal price, the shareholders have a remedy.<sup>66</sup>

That these remedies are, in the very great majority of cases, ineffectual has been reported by the Securities and Exchange Commission. There are a number of reasons for this ineffectuality, among them the wide scattering of certificate holdings among small security holders,<sup>67</sup> the cloak of secrecy which surrounds most transactions thereby keeping the shareholders in ignorance of the abuses or at least making them difficult of proof, the expense of costly litigation, the power of management, disappearance of wrongdoers, financial instability of defendants, settlement of actions commenced by individual stockholders, and many others.<sup>68</sup>

Thus it would seem that, in accordance with the views of almost all the impartial writers, committees and commissions,<sup>69</sup> there was an urgent need for statutory regulation. State regulation has been, and necessarily must be, inadequate.<sup>70</sup> The real need was for federal legislation.

### III. THE INVESTMENT COMPANY ACT OF 1940

The Investment Company Act is aimed to remedy just such abuses as have been discussed without unduly disrupting existing contractual relations.<sup>71</sup>

<sup>64</sup>*Geddes v. Anaconda Copper Mining Co.*, 254 U. S. 590, 41 Sup. Ct. 209 (1921); *Wardell v. Railroad Co.*, 103 U. S. 651, 26 L. ed. 509 (1880); U. S. Shipping Board Emergency Fleet Corp. v. South Atlantic Dry Dock Co., 300 Fed. 56 (C. C. A. 5th 1924); STEVENS, CORPORATIONS (1938) §§ 142 and 143.

<sup>65</sup>*Carr v. Kimball*, 153 App. Div. 825, 139 N. Y. Supp. 253 (1st Dep't 1912), *aff'd*, 215 N. Y. 634, 109 N. E. 1068 (1915).

*Quaere* whether by analogy the excess could be recovered where exorbitant management fees are charged.

<sup>66</sup>STEVENS, CORPORATIONS (1938) § 143, at 572.

<sup>67</sup>"... who were virtually powerless to exercise any concerted effort to prevent or eliminate various malpractices and deficiencies, or to remove incompetent or dishonest management." REPORT, Part III, Ch. I, Sec. III, A, p. 32.

<sup>68</sup>See Legis. (1930) 44 HARV. L. REV. 117, 118; Flynn, *Let's Regulate the Investment Trust* (1940) 102 NEW REPUBLIC 505.

<sup>69</sup>Ottinger, Albert, Attorney General, *Investment Trusts—A Survey of the Activities and Forms of Investment Trusts with Recommendation for Statutory Regulation* by the New York Department of Law (1927) and *Supplementary Survey* (1928) in KEANE, MANUAL OF INVESTMENT TRUSTS (1928) 651 *et seq.*, 741. See also (1928) 16 I. B. A. A. BULL. 93; *Report of the Committee on Investment Trusts of National Association of Security Commissioners* in ROBINSON, INVESTMENT TRUST ORGANIZATION AND MANAGEMENT (1929) 572-82; KEANE, *op. cit. supra* at 1608-20; FLYNN, INVESTMENT TRUSTS GONE WRONG (1930); Legis. (1930) 44 HARV. L. REV. 117; Flynn, *Let's Regulate the Investment Trust* (1940) 102 NEW REPUBLIC 505.

<sup>70</sup>Legis. (1930) 44 HARV. L. REV. 117.

<sup>71</sup>Provisions exempting contracts which were operative on or before March 15th, 1940 are numerous. See in particular 15 U. S. C. A. §§ 80a-4 (c) (10), 80a-4 (c) (15), 80a-21 (b) (1940).

Section 4 classifies investment companies as face amount certificate companies, unit investment trusts and management investment companies. The main discussion herein has been of management companies and the consideration of the legislation will, in general, be similarly limited. Face amount certificate and unit type companies are defined substantially as they already have been above, and management investment companies are defined so as to include all other types. For the purposes of registration and disclosure to the public, Section 5 subclassifies management investment companies into open-end and closed-end companies and into diversified and non-diversified investment companies.

The qualification of a diversified investment company is that, as to 75% of its cash and securities assets, it must not invest more than 5% of its assets in the securities of any other one company and may not own more than 10% of the outstanding voting securities of that company.<sup>72</sup>

Section 8 (b) (1) provides that investment companies must register as within one of these classes and subclasses, and Section 13 provides that investment companies may only change their subclassification or their fundamental management policy by vote of a majority of the outstanding voting securities.

This division into subclassifications and registration thereunder provides notice to the investing public of the type of investment which will be made by a particular company.

The first-mentioned abuse was the removal of funds from the control of those who supply them. It was pointed out that senior securities, without voting power, were issued to the investing public whereas all or a controlling block of the voting common stock was retained by the management. In this connection it was also pointed out that by leverage of the junior securities the management could realize enormous profits while the public shareholders received a comparatively minute profit.<sup>73</sup>

Section 18 of the *Bill* provided that, with certain exceptions, all future stock issues were to be of common stock without any preference, with equal voting power, and with the right to purchase ratably the stock of any new

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<sup>72</sup>The Wagner-Lea Bill, S. 3580, further qualified a diversified investment company as one (a) whose portfolio turnover does not exceed 150% in one year, (b) which is a non-leverage company and (c) which does not own or control any voting stock of another investment company, and further subdivided non-diversified companies into securities trading and securities finance companies, a securities trading company being one which met qualification (a) and a securities finance company being any other management investment company.

It is submitted that these further qualifications and subclassifications would have better apprised the investing public of the investment policy of each management investment company.

<sup>73</sup>See in particular *supra* note 13.

issue, and provided for redistribution, on application to the Securities and Exchange Commission, of existing voting rights after two years from the date of the enactment of the Bill.

This provision, although it would unquestionably have remedied the abuses named, raises the constitutional question of the right of Congress to delimit the type of security which a prospective investor might purchase and to interfere with existing rights of security holders, and also the question of the advisability of so broad a delegation of authority to the Securities and Exchange Commission.

Probably for these reasons Section 18 of the *Act* does not attempt to limit the classes of stock which may be issued, but limits the issue or sale of senior stock securities of an open-end company by certain regulations as to asset coverage, dividends, right of such shareholders to elect minority directors, and others. Clearly, the Act does not, in this respect, offer the investing public as adequate protection against complete voting control by management as would the provisions of the Bill. The seriousness of this defect in the attempt to remedy existent abuses by legislation becomes obvious in the consideration of Section 16 hereinafter.

Where the public investors have acquired voting stock their voting rights are protected by Section 20 which places certain limitations on the soliciting of proxies and prohibits voting trusts.

Further provision delimiting the control of management and provision for a degree of control by the investing public is made in Section 15. Subdivision (a) states that investment advisers must be under a contract approved by a majority vote of the holders of voting securities. Further, this contract must clearly state the compensation, must be for only a two year period, may only be renewed with the annual approval of a majority of such security holders, must be terminable on 60 day notice by the board of directors or by a majority of the shareholders, and must automatically terminate on assignment. Section 15 (b) requires that contracts with principal underwriters be for a maximum of two years, be non-assignable and renewable only by the annual approval of the board of directors or a majority of the security holders, and Subdivision (c) requires the approval by a majority of the disinterested directors or stockholders of any contract with an investment adviser or principal underwriter.

It is possible that even these provisions, when read in conjunction with Section 10 of the Bill, would effectually serve the declared public policy of reserving to the investors a reasonable degree of control over management without hampering the efficient conduct of an investment company's business

by that management. But, again, the provisions of Section 10 of the Act differ widely from those of Section 10 of the Bill.

Section 10 deals with affiliations of directors involving conflicts of interests. Here, for reasons already pointed out, investment bankers and brokers are in a special class and both the Bill and the Act have recognized this fact. The Bill contains several separate regulations appertaining thereto. Subsections (f) and (g) protect against self-dealing by investment bankers and brokers, subsection (c) provides that an investment banker or broker may only be a director, officer, or manager of one investment company, and subsection (e) (2) provides that an investment banker or broker may not be a director or officer of an investment company if he is a director or officer of a corporation whose securities that investment company has purchased. It should be noted that this last subsection prohibits such persons from becoming a director of *any* type investment company whereas subsection (e) (1) prohibits a director of an industrial company in whose securities a *diversified* investment company has invested from becoming a director of that investment company.<sup>74</sup>

The distinction between investment bankers as directors and other directors of issuing corporations is, of course, justified by the history of the investment company field. But, in a provision intended to prevent conflicts of interests on the part of directors, the distinction between investment companies which do not own more than 5% (or 10% as provided in the Act) of the securities of an issuer and those which own larger blocks of stock is a little more difficult to comprehend. It was understandable that the Bill should clearly subclassify management investment companies into those which did not own more than 5% and those which did, and, further, should carefully avoid any attempt to legislate out of existence the investment companies which choose to invest in large blocks of the stock of a particular company. All that is required is registration and full disclosure of that fact to the investor. However, here there is a completely different problem. It would seem that there is certainly no more, and probably less, reason for allowing common directors in the case of the investment company which owns a large block of stock. The only possible justification for the distinction would be a desire to secure a board of directors for a diversified company which has no particular interest in any one industrial company and thus will fairly "diversify" the portfolio. The same result could have been achieved by prohibiting directors of issuing companies from becoming directors of *any* type investment company.

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<sup>74</sup>These two subsections would effectively deal with the abuse illustrated *supra* note 45 and text thereto.

Section 10 of the Bill also provided: subdivision (a) (1), that only a minority of the board of directors may be affiliated with the manager or sponsor of the investment company, and, subdivision (d), that the same person may only be an officer or manager of one investment company.

Admittedly this section of the Bill is stated so confusingly and worded so complicatedly that it is extremely difficult to comprehend or interpret, and thus should have been reworded.

Section 10 of the Act, however, is not merely a rewording of the provisions of the Bill but a new section providing in effect that: *first*, only 60% of the board of directors of an investment company may be affiliated with that company (as opposed to the minority allowed by the Bill); *second*, a director or officer of the company may not serve as broker or principal underwriter if a majority of the board are brokers or underwriters, as the case may be; *third*, no investment company may have as director, officer or employee an investment banker if a majority of the board are investment bankers; and, *fourth*, a majority of the board of directors may not be officers or directors of any one bank (as opposed to the Bill provision absolutely barring interlocking directorates and resultant conflicting interests). The Act completely omits the provisions found in the Bill that only a minority of the board may be affiliated with any other one company, and that the same person may only be an officer or manager of one investment company.

The omission of the latter provision is perhaps justified in that it is harsh to prohibit a person, no matter how able, from serving more than one company. It is submitted, however, that the omission of the former provision and the changes made in the rest of the Section have gone far toward defeating the entire purpose thereof, namely, the prevention of the known abuse of interlocking directorates and conflicting interests of management.

Self-dealing, loans to insiders, and repurchase of shares from insiders, which were mentioned herein as the other abuses resulting from the conflicting interests of management, are adequately dealt with in Sections 17, 21, 22 (a) and 23.

There have been many instances of self-dealing or loans to insiders by management which were the basis of a civil action by an individual shareholder. Of course the amount of damage to any one shareholder was negligible, thus the directors would settle that action as soon as it was commenced in the hope that none of the other shareholders would learn of it.<sup>75</sup> Section 33 adequately provides for this type of situation.

In the discussion of the abuse of pyramiding it was stated that sponsors or promoters of one investment company should not be permitted to form

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<sup>75</sup>Hearings before Subcommittee, Part I, p. 210.

another until they have disassociated themselves from the first company, or until a number of years have elapsed. This is exactly the position taken by the Bill in Section 11 (a) and (b). True, because of the separation into two subsections, there is a certain ambiguity. Subsection (a) provides that a promoter who forms an investment company may not be an officer, director, manager, *etc.* of that company if he has formed a previous one within the preceding five years. As worded this would mean that even a promoter who forms a company and then entirely disassociates himself therefrom would not be permitted to form another for five years. It is submitted that this ambiguity did not justify the complete disappearance of the section from the Act and the substitution of a provision dealing with exchanges of securities.<sup>76</sup> Thus, in spite of a clear declaration of policy against pyramiding,<sup>77</sup> the most effective provision against that evil has been omitted and a safeguard against one of the occasional minor incidents thereof has been substituted.

Sections 12 (d) and 14 also deal with the problem of the size of investment companies. The former provides certain limitations on the purchase by one investment company of the securities of another investment company.

In view of the policy throughout the legislation not to substitute the discretion of Congress or the Securities and Exchange Commission for the discretion of management, that is, not to tell managers how to run these companies, the draftsmen were reluctant to delimit in any way the securities in which an investment company may invest its fund. Thus, there is no requirement, as there is in the case of savings banks and life insurance companies, that they must invest in legals. Lacking such a requirement, it would seem that there should be some limitation on the size of the companies, *i.e.*, the maximum amount which any one investment company should have to invest, particularly in view of the absence of such a prohibition against pyramiding as was contained in Section 11 of the Bill. Such a provision, although possibly arbitrary, would be justified by the fact that the largest investment companies have sustained the largest proportionate losses.<sup>78</sup>

The provision advocated would not delimit the amount which might be earned, but the limitation would be placed on the issue of new securities to

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<sup>76</sup>Section II provides that an open-end investment company may only exchange the securities of its company for the securities of another open-end company on the basis of the net asset values of the respective securities.

<sup>77</sup>Section I, *Findings and Declarations of Policy*: "... the national public interest and the interest of investors are adversely affected . . . (4) when the control of investment companies is unduly concentrated through pyramiding."

<sup>78</sup>For example:

Goldman Sachs Trading Corp.	—	\$326,000,000 to \$40,000,000
United Founders	—	500,000,000 to 40,000,000
Central States Electric Corp.	—	134,000,000 to 15,000,000
Insull Utilities Invest. Co.	—	250,000,000 to 33,000,000

raise capital when the company already has a named allowed sum, or more, of working capital. Thus an investment company could start with the named sum permitted management investment companies and increase its total assets to any amount by wise investment and resultant earnings, but the enormous structures created by Goldman Sachs, or by United Founders or by Insull could not have been repeated.

In spite of the obvious advantages of such a limitation on size, the section entitled "Size of Investment Companies" (§ 14) not only does not put a top figure on size but approaches the problem from exactly the opposite point of view and provides for a minimum net worth of an investment company before it may make a public offering of its securities. This would not seem to be in furtherance of the declared policy against pyramiding.

On the other hand, subdivisions (c) and (d) of Section 20, which prohibit cross-ownership of voting securities and circular ownership of any securities, are clearly in furtherance of such policy. It is regrettable that there are no other, bolstering, provisions.

The Act contains certain provisions aimed to meet the abuses herein called "excessive charges for management" and "hidden fees," but here again its provisions leave something to be desired. Section 18 (d) prohibits the issue of purchase warrants except ratably to a class of shareholders, and provides that they must expire after four months; Section 22 (b) prohibits the sale of redeemable securities to an underwriter or dealer at a discount except in accordance with certain rules; and Section 22 (c) gives the Commission power to prevent or remedy exorbitant sales loads. This is excellent so far as it goes, but a clear statement of permissible bases of management compensation would more effectually preclude excessive charges, and, further, there is no regulation as to the unreasonably large percentage which most investment companies are now paying for "management."

Throughout this article the position has been taken that it is of utmost importance that the shareholders or participants in the trust have some control over management, that they have some protection against a complete change of management personnel without their knowledge and approval, and that they be assured of the power to dismiss an incompetent management. Section 16, which provides that directors must be elected by a majority of the voting security holders, would tend to assure the desired control and protection if an accompanying section, relating to stock issue, would insure to the investing public a reasonable percentage of the voting stock. But, as was pointed out above, Section 18 in dealing with stock issue did not adopt the prohibition against the issue of more than one class of stock which was

embodied in the Bill. Thus, the possibility of "insiders" retaining the voting stock and electing "insiders" as directors remains a potential evil.

Other safeguards contained in the legislation are: Section 12, prohibition of margin purchases, authority to Securities and Exchange Commission to regulate short sales and dealing in and distribution of own securities; Section 19, requirement of disclosure of sources of dividends and prohibition of dividends unless there would remain certain prescribed asset coverage for the remaining securities; Section 32, requirement of financial statement certified by a public accountant chosen or approved by the security holders.<sup>79</sup>

In order to avoid rigidity and inflexibility and for the purpose of enforcement, the Securities and Exchange Commission is empowered to issue rules and regulations and to enforce certain penalties for non-compliance.<sup>80</sup> Provision is also made for appeal to the United States Circuit Court of Appeals from such orders and findings of the Commission.<sup>81</sup> In short, the mechanical operation of the Investment Company Act will be substantially similar to that of the Securities and Exchange Act and the Public Utility Holding Company Act.

#### IV. SUMMARY AND CONCLUSIONS

It is submitted that the regulation of the purchase by one investment company of the securities of another investment company, regulation of exchange of securities, and prohibition of cross-ownership and circular ownership, without a prohibition against recurrent promotions and a limitation as to permissible size such as that advocated herein, will not remedy the evil of pyramiding nor completely eliminate the possibility thereof. It is conceivable, however, that this defect will be remedied by the rules and regulations promulgated by the Securities and Exchange Commission in furtherance of the declared policy against pyramiding.

Although certain constructive criticisms of the Investment Company Act have been offered herein, there should be no implication that the Act has failed in its purposes. The very fact that regulatory legislation has been enacted and an administrative commission empowered to "police" the industry in the interests of the investing public is in itself a real and substantial safeguard to that public. In spite of the fact that little if any control has been shifted from the hand of the managers to the participants in the investment trusts, the management's use of that control can no longer be self-serving; hidden fees for sponsors and managers are no longer possible; sound accounting and business practices, reputability of management and

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<sup>79</sup>Also see §§ 30, 31, 34 and 35. 15 U. S. C. A. §§ 80a-30, 31, 34, 35 (1940).

<sup>80</sup>See §§ 38-42, 48, 49. 15 U. S. C. A. §§ 80a-38-42, 48, 49 (1940).

<sup>81</sup>Section 43. 15 U. S. C. A. § 80a-43 (1940).



financial stability of the investment company at the time of the issue of new securities are assured; protection against the issuance of new securities with discriminatory provisions is provided to the holders of outstanding securities; and regulation of the issuance of senior securities operates as protection against the leverage of junior securities.

It is difficult to see how regulations providing such a setting for investment companies add to "the mountain of laws, rules, regulations, releases and bulletins which constitute ever increasing barriers to the free flow of capital."<sup>82</sup> It would rather appear that such a setting would itself be an inducement to investment and thus increase and expedite the free flow of capital.

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<sup>82</sup>Statement of F. Eberstadt, *Hearings before Subcommittee, Part II*, p. 257.