THE YALE LAW JOURNAL

EDITORIAL BOARD

ROY H. STEYER
Editor-in-Chief

GEORGE D. BRADEN
POTTER STEWART
Comment Editors

LEONARD S. SHERIFF
JOHN M. WOOLSEY, JR.
Note Editors

JOSEPH S. ISEMAN
Article and Book Review Editor

JOHN E. ECKLUND, JR.
Case Editor

SHIRLEY ADELSON
DAGGETT H. HOWARD
WILLIAM A. W. KREBS, JR.
PHILIP A. LOOMIS, JR.
MANSON F. MCCORMICK
DANIEL V. MCNAMEE, JR.
DONALD T. ROSENFELD
MILTON M. RULNICK
WILLIAM M. SAYRE
HAROLD A. SEGALL
ARTHUR STERN, JR.

Subscription price $4.50 per year *80 cents per number*

Canadian subscription price $5.00 per year; Foreign, $5.25 per year
Yale Law Journal Company, Inc., Box 401A Yale Station, New Haven, Conn.

THE INVESTMENT COMPANY ACT OF 1940

THE Investment Company Act of 1940[1] is the newest comprehensive piece of national legislation drawn in the "interest of investors" and entrusted for administration to the Securities and Exchange Commission. That its passage was achieved with the complete cooperation of the industry[2] adds significance to the Act, whether it be considered purely as a much needed regulatory measure in that particular industry, or whether it be considered as suggesting the temper of any further federal legislation supervising corporations.

Essentially, investment companies are large, liquid pools of public savings entrusted to the company management for investment in productive enterprise. Normally they invest for the yield, including capital appreciation,[3] and

1. Pub. L. No. 768, 76th Cong., 3d Sess. (Aug. 22, 1940). The Act is divided into three titles of which Title I is addressed to investment companies and is separately known as the Investment Company Act of 1940. Except where otherwise indicated, this Comment is restricted to Title I. Title II regulates investment advisers. Title III amends § 8(a) of the Securities Act of 1933, 48 STAT. 74 (1933), 15 U. S. C. § 77 (1934).

2. *Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce of the House of Representatives on H. R. 10065,* 76th Cong., 3d Sess. (1940) 62, 63.

3. Capital gains are treated as income by most investment companies, and are so regarded for income tax purposes. INT. REV. CODE, § 22(a), Reg. § 19.22(a)-19 (1936).

not for the control of productive wealth — a feature which distinguishes them from holding companies. Shareholders are induced to purchase investment company securities by the prospect of obtaining a diversification and expert management of their investments which, as individuals, they could not afford to command. Frequently the sales and promotional literature of these companies, by stressing the necessity of providing for old age and emergencies, has analogized them to banks and insurance companies, except that they are not limited to so-called "legal" investments.[4] In organization and practice they have assumed an almost infinite variety of forms. Among the principal differentiating factors are the nature of their legal organization, the amount of discretion left in management to change the composition of the portfolio, capital structure, investment policy, security-marketing policy, and the designation as "open-end" or "closed-end." An open-end company is one whose shares are redeemable at a figure roughly comparable to their proportional share of the underlying assets of the company.[5] To avoid a constant shrinkage of its funds, this type of company is constantly selling as well as redeeming its shares, and is therefore closely geared to security-distributing machinery. Closed-end companies are those without this redemptive feature.

Born in boom times,[6] weaned upon the 1929 crash, and plagued with a fringe of thoroughly dishonest manipulators, the investment company industry grew without any effective regulation,[7] internal or external, to reap the whirlwind. Of course there were many substantial and successful companies, but the picture presented by the Securities and Exchange Commission after a four-year investigation[8] showed fantastic abuse of trust by management and wholesale victimizing of investment company security holders.[9] In general

4. REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1939) Pt. I, c. 3, p. 60, 61. (Hereafter cited as SEC REPORT).

5. The official definition in the Act is "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer." § 5(a)(1).

6. Out of 1200 investment companies whose dates of organization are known, approximately one-half were organized in 1927-1929. Total assets of all investment companies increased ten-fold to almost $8,000,000,000 from the end of 1926 to the crash in 1929. SEC REPORT, Pt. III, c. 1, p. 3-4.

7. For the inadequacy of the common law to protect investment company shareholders, see Comment (1930) 44 HARV. L. REV. 117. For a summary of applicable state and federal legislation prior to 1937 and its inadequacies, see Comment (1937) 46 YALE L. J. 1211, 1217 *et seq.*

8. In § 30 of the Holding Company Act, the SEC was directed in broadest possible terms to study the functions and activities of investment companies and to report back to Congress. 49 STAT. 837 (1935), 15 U. S. C. § 79z-4 (Supp. 1939). The material for the study was collected by means of specially prepared questionnaires, preliminary discussions and conferences with representatives of investment trusts, field studies, and public examinations. SEC REPORT, Pt. I, c. 1, p. 5 *et seq.*

9. SEC officials estimate that between 1929 and 1936 investors suffered an aggregate capital shrinkage of approximately 40% in all types of investment companies. *Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S.*

the abuses stemmed from the control of investment companies by banking, brokerage, or dealer interests — a control founded in complicated capital structures, disguised behind meagre, and often misleading, reports to stockholders, and exercised to benefit the sponsor without regard to any stewardship on behalf of the investors who put up the money.

Severe criticism of the industry, both from within and from without, had not awaited the publication of the SEC report.[10] Various types of moderate reform were attempted, such as a vigorous enforcement of anti-fraud legislation in New York,[11] the self-regulation of the industry under an NRA code,[12] and the adoption of fairly comprehensive disclosure requirements by various important security-distributing states.[13] Extremists went so far as to suggest that the whole investment company industry was a parasite upon the stream of industrial earnings, levying tolls upon the yield of blue-chip securities to pay administration costs and income taxes that were not economically justified.[14]

While it was never seriously proposed to outlaw investment companies entirely, the original bill for federal regulation, submitted by the SEC to Congress last March, surpassed even the Holding Company Act in grants of discretionary power to the Commission.[15] Whether it would have been politically possible to pass the bill in its original form is questionable. At any rate, the present Act is a drastic modification, rewritten entirely by the Commission and the industry, and passed by Congress without debate as a tribute to the cooperative spirit which fathered it.[16] Where the original draft left the Commission with power by rule and regulation to implement the broad policies of the bill, the present Act generally sets certain maxima of

3580, 76th Cong., 3d Sess. (1940) Pt. I, p. 34; Pt. II, p. 783. (Hereinafter cited as *Hearings*).

10. FOWLER, AMERICAN INVESTMENT TRUSTS (1928); RIPLEY, MAIN STREET AND WALL STREET (1928); WILLIS and BOGEN, INVESTMENT BANKING (1929) 183; Cabot, *The Investment Trust* (March 1939) 163 ATLANTIC MONTHLY 473; Comment, *Statutory Regulation of Investment Trusts* (1939) 44 HARV. L. REV. 117.

11. For the failure of this type of control see Ottinger and Shea, *A Survey of the Activities and Forms of Investment Trusts with Recommendations for Statutory Regulation by the New York State Department of Law* (1927).

12. Article VIII of the proposed Code of Fair Competition for Investment Bankers outlawed self-dealing and required full disclosure to stockholders of investment companies. *Hearings*, Pt. II, p. 641.

13. Ohio's famous "Q-3" regulation of open-end security distribution was adopted by the National Association of Securities Commissioners in 1939 as a guide to the enforcement of "Blue Sky" legislation in all states. *Hearings*, Pt. II, p. 548.

14. The two best critiques of the investment company institution, written in contemplation of its introduction into France, analyze and refute this argument. CHARIGNON, SOCIETES DE PLACEMENT ET SOCIETES DE CONTROLE (Lyon, 1932) 222; SCHWOB, LES "INVESTMENT TRUSTS" AUX ETATS-UNIS (Paris, 1934) 151. See also FLYNN, INVESTMENT TRUSTS GONE WRONG (1931) 179.

15. This original bill was S. 3580, 76th Cong., 3d Sess. (1940).

16. 86 CONG. REC., Aug. 13, 1940, at 15691.

regulation, leaving in the Commission a discretionary power only to exempt and minimize.[17]

The method of regulation varies with different sections of the Act — the whole being a compound of disclosure requirements, insurance of at least a minimum voting control by stockholders on key questions, and direct prohibition of certain practices which are either themselves fraudulent or serious temptations to fraud.[18] Although the role of the Commission is ostensibly little more than that of a watch-dog, with power to enforce the Act by stop-order, injunction, and criminal prosecution, it seems likely that the Commission will exercise considerably greater power by way of persuasion than a literal reading of the Act would imply.[19] This Comment will attempt to specify and illustrate the observations advanced above, treating the significant sections of the Act in groups according to the general problem with which they deal.

Definitions, Classifications, Registration. Under penalty of exclusion from all channels of interstate commerce,[20] investment companies are required to register with the SEC, after which a company is subject to all other provisions of the Act.[21] Therefore, to appreciate the scope of this legislation it is necessary to inquire, first, how the term "investment company" is defined, and, secondly, how this heterogeneous group is sub-classified for particular treatment.

The basic definition of "investment company" in Section 3(a) includes a functional and a formulaic test: it catches those companies which "are or hold themselves out to be engaged primarily" in the investment business, and also those companies 40% of whose assets are in investment securities. So broad a definition is quite necessary to cover the case of fixed trusts and other non-trading investment companies, but it would, unless qualified, include holding companies, underwriting companies, banks, and other institutions, for whose benefit a lengthy list of exceptions to the definition had

17. For instance, § 30 of the present Act permits the Commission to eliminate from but not add to the list of periodic reports required of an investment company. *Cf.* § 14 of the Holding Company Act which, within broad limits, permits the Commission to determine the form and content of comparable reports by holding companies. 49 STAT. 827 (1935), 15 U. S. C. § 79n (Supp. 1939). Such a comparison could be made with many sections of the two Acts.

18. Sections 19 on dividends and 25 on reorganizations are typical disclosure sections. Sections 13 and 18 illustrate the stockholder control theory. And §§ 9, 10, and 12 contain many of the direct prohibitions.

19. See note 70 *infra*.

20. § 7. This includes the mails and facilities of national securities exchanges registered under the 1934 Act and applies to transactions in the company's own securities as well as to the carrying on of the investment business. For a collection of authorities supporting the constitutionality of such sanctions, see Securities & Exch. Comm. v. Jones, 12 F. Supp. 210, 213 (S. D. N. Y. 1935).

21. Section 8 is the registration section. Other sections of the Act apply to "registered investment companies."

to be drawn.[22] In spite of this complexity, or perhaps because of it, the Section appears to have brought under the Act all and only those companies which were supposed to be covered.[23]

Registered investment companies are divided into three principal classes. "Face-amount certificate companies," which sell unsecured debentures upon the installment plan, and "unit investment trusts," which sell aliquot shares in a fixed or semi-fixed bundle of securities deposited with a trustee, are highly specialized types for which special regulation is provided. It is with the remaining classification, the "management investment companies," that the Act is principally concerned.[24]

Management companies again are classified two ways: (a) open and closed end companies, and (b) diversified and non-diversified companies.[25] A diversified company is one which meets certain statistical requirements for a diversified portfolio.[26] The most important registration and disclosure requirements depend upon this scheme of classification.

Disclosure. One of the greatest abuses of investment company practice had been the rapidity and irresponsibility with which some managements totally changed the nature of their business. Stockholders who had invested in self-styled diversified companies were committed overnight to highly illiquid positions in banks, barge-lines, transportation, manufacturing, or any

22. Subsection (b) exempts from § 3(a) those companies which are primarily engaged in other business through wholly owned subsidiaries and those which the Commission finds to be so engaged through majority owned subsidiaries or controlled companies, notwithstanding the 40% test. Other companies specifically declared outside the basic definition are issuers having less than 100 security-holders, underwriters, banks, insurance companies, trustees, companies subject to regulation under the Interstate Commerce or Holding Company Acts, eleemosynary institutions, and the like. § 3(c)(1-15).

23. The formula was tested against a list of 1800 companies registered under the 1933 and 1934 Acts. *Hearings,* Pt. I, p. 176-177. Section 6 also exempts various particular types of investment companies and gives the Commission power to make any further exemptions consistent with the general purpose of the act. Compare the similar power granted by § 3(d) of the Holding Company Act. 49 STAT. 810 (1935) 15 U. S. C. § 79c(d) (Supp. 1939).

24. § 4.

25. § 5. It is not the policy of the Act to encourage any one type of company, much less to prohibit the operation of any type. So long as a company tells its stockholders honestly what it proposes to do, it is free to pursue its own portfolio policy. Compare § 586 of the recent Australian Investment Company Act, which sets rigid standards of portfolio diversification to which all investment companies must conform.

26. Section 5(b)(1): "'Diversified company' means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer."

This gives the diversified company a reservoir of 25% of its assets for investment in underwritings or special situations without conforming to the 5%-10% restrictions.

other business which caught the managerial fancy.[27] It was originally thought by the SEC that this abuse could best be eradicated at the source, by cleaning up investment company charters and limiting their corporate power to the investment business. This, however, would have worked a hardship upon such socially useful companies as Atlas, for instance, which supply large amounts of equity capital to growing industry, and which, for their own protection, must be able to step in and manage a bad investment.[28]

As a compromise solution, Section 8 of the present Act requires each company to make certain "recitations of policy" in its registration statement and to adhere to these policies until a change is authorized by vote of the stockholders pursuant to Section 13. Declarations are required as to the classification and subclassification in which a registrant proposes to operate; also as to borrowing, issuing senior securities, underwriting, concentrating investments in a particular field, commodity and real estate purchases, loans, portfolio turnover, and any other matters which the registrant elects to treat as "matters of fundamental policy." He may indicate the extent to which he proposes to engage in these activities or the extent to which he reserves freedom of action.[29] If the Commission does not permit these recitations to become conventionalized, and therefore meaningless, they should give stockholders reasonable warning of, and control over, fundamental shifts in company policy without incurring the dangers of rigidity and standardization to which government control of business policy is subject.

Apart from these policy declarations, the registration of an investment company will require about the same type of disclosure as the Securities Act of 1933 and the Securities and Exchange Act of 1934, with appropriate provision for avoidance of duplicate filings under the various Acts.[30] Registration statements must be kept up to date with periodical reports to the

27. Most spectacular was General Investment Company's sudden acquisition of a $70,000,000 subway in Buenos Aires which tied up practically all of its assets and was later sold for about 10% of its cost. *Hearings*, Pt. I, p. 121, 127. Other instances where large sums were similarly lost abound in the history of Goldman Sachs, Phoenix Securities, and the Founder's Group. See SEC REPORT, Part III, *passim*.

28. Agitation for a federal incorporation act as the only practical means of correcting state laxity continues, however. Bills to this effect were introduced three times in Congress in the last two years—S. 330, 76th Cong., 1st Sess. (1939), S. 10, 75th Cong., 1st Sess. (1938), S. 3072, 75th Cong., 3d Sess. (1938). The SEC has concluded that federal incorporation of interstate corporations is desirable. SEC REPORT ON THE STUDY AND INVESTIGATION OF WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1938) Pt. VII, 412.

29. Section 8(b)(1) and (2) sets forth the registration requirements. Section 13 requires approval by a majority of voting securities for any deviations therefrom except for portfolio turnover and for a shift from the unrestricted classification "non-diversified" to the restricted "diversified" classification. These exceptions avoid hamstringing management initiative in time of crisis when liquidation of special situations may be urgently required and would involve exceeding the expected rate of portfolio turnover or qualifying as a diversified company through temporary reinvestment in blue chips.

30. §§ 8(c) and 24.

Commission and to stockholders, the maximum requirements of which are set forth in Section 30.[31]

In this connection it is noteworthy that the Commission is granted one very important discretionary power — that of prescribing a "reasonable degree of uniformity" in accounting practice, both for the purpose of reports under Section 30 and for the maintenance of the complete financial records required to be kept by Section 31.[32] Owing to the liquid nature of most investment company assets, and their hour-to-hour revaluation upon the market, accounting precedents from industrial companies are of limited application. The Commission has indicated that an entirely different set of accounting rules from those effective under the earlier Acts will be promulgated. Inasmuch as these rules have not appeared, it is possible only to state that the principal problems involved will be those of defining a capital impairment, the treatment of unrealized profit and loss, and some modification of the usual distinction between fixed and current assets which seems inapplicable to an investment company balance sheet.[33] In addition to their disclosure value, these rules will manifestly affect an evaluation of certain other sections, notably those on dividends, reorganization, and capital structure.

All of these disclosure provisions are designed as much to safeguard the potential purchaser of investment securities as the individual who is already a stockholder. The security factory of the past, with its high-pressure salesmanship and alluring advertisements, will find operation more difficult when all of its sales literature, as well as the official prospectus, must, under Section 24, pass muster for truth and fairness with the Commission.[34]

Personnel and Self-Dealing Provisions. Four sections of the Act directly attack the most obvious single weakness in former investment company practice — the complete lack of uniform provision for insuring the independence of management and its fidelity to its own stockholders. Section 9 disqualifies for management positions known criminals, including those under injunction in connection with any security transaction.[35] Section 10 provides

31. See note 17 *supra.*

32. § 31(c).

33. See ROBINSON, INVESTMENT TRUST ORGANIZATION AND PRACTICE (rev. ed. 1929) Ch. 17, and statement of chief SEC accountant before Senate Sub-committee, HEARINGS, Pt. II, p. 906 (summary of special accounting problems in this field); *Statement on Investment Trusts of the Management Type by the Committee on Stock Listing of the New York Stock Exchange* (1931) (various desiderata which the SEC may use as guides); Kaplan and Reaugh, *Accounting, Reports to Stockholders, and the SEC* (1939) 48 YALE L. J. 935.

34. To the safeguards already surrounding the promotion of new companies by reason of the disclosure requirements of the Securities Act of 1933 [48 STAT. 74 (1933), 15 U. S. C. § 77 (1934)] is now added § 14, which requires that new investment companies have a net worth of $100,000 before offering securities to the public, an effective discouragement to the shoestring security peddler.

35. This is a flat prohibition qualified by an exemptive power in the Commission. The original draft of the section, which required all investment company officers and

for an independent board of directors and independent investment advice. Section 16 prevents sale of control and transfer of directorships without stockholder consent. And Section 17 outlaws self-dealing transactions between individual members of management and the company itself.

In connection with Sections 9 and 16 there ought not be much administrative difficulty. The question has arisen whether an injunction running against "The *X* Co. and its officers" serves to disqualify an individual who was an officer at the time of the injunction but is such no longer, or an individual who was not an officer at the time of the injunction but has since become one.[36] Whatever the decision, the Commission has ample exemptive discretion to avoid undue hardship for innocent parties. Section 16, which prohibits interim appointment of directors unless two thirds of the resulting board will have been elected by the stockholders, is salutary insurance against a repetition of such scandals as the sale of control of Continental Securities Co. in 1937 to freebooters who arranged a seriatim resignation of the old directors, elected their own nominees to the board, and then raided the portfolio of their acquired company to reimburse themselves for the expense of purchasing it.[37]

Sections 10 and 17 deal with the problem of managerial responsibility in the broadest sense and, as a result of combining at least two distinct theories, are excessively complicated. It was suggested during the hearings on the original bill that this whole problem could be solved most expeditiously by declaring investment company managements to be trustees in fact with trustee obligations to their stockholders.[38] This proposal, however, which would have involved a drastic revision of managerial responsibility, was rejected except to the extent that "gross abuse of trust" was made a ground for restraining the guilty party from further connection with the industry.[39]

A second theory proposed to guarantee the independence of management from any "outside" domination and let the self-interest of arm's-length bargaining regulate management. A third theory proposed to outlaw specific transactions or types of transactions where experience had shown the danger

---

directors to register as individuals with the SEC and become subject to such disqualification as that body should propose drew a storm of protest from the industry. *Hearings*, Pt. II, pp. 387, 411. The metamorphosis again illustrates the specification of standards in the final draft of this Act and the limitation of SEC discretion to exemptions.

36. § 9(a)(2). Subsection (b) directs the Commission to exempt by order any person for whom this incapacitation would be "unduly severe."

37. *Hearings*, Pt. I, p. 59. SEC REPORT, Pt. III, c. 2, p. 371

Section 16 has the incidental effect of preventing the future formation of investment companies under a common law or Massachusetts trust agreement. Only trusts already existing are exempt from the requirement that shareholders elect their own directors. Such election avoids the limited liability without which these trusts would not be formed. Williams v. Milton, 215 Mass. 1, 102 N. E. 355 (1913).

38. *Hearings*, Pt. I, p. 262.

39. § 36.

of double-dealing. In general Section 10 is based upon the second theory, and Section 17 upon the third.

Section 10 requires that when a liaison exists between an investment company and a broker, underwriter, or other outside interest, a certain percentage of the investment company directors must be entirely independent of, and uncontrolled by, that interest.[40] A conflict of loyalties fatal to the "independence" of any individual arises when that individual is a director, officer, or employee of an investment company and at the same time an "affiliated person" of the brokerage, underwriting, or other such firm with which the investment company deals. Depending upon which of these types of conflict is envisaged, the required percentage of independent directors varies. Thus only 40% need be independent of the investment advisor as a check upon the advice given,[41] but a majority must be independent of the regular company broker or underwriter, since these are the parties in whose self-interest it is most directly profitable to mis-use investment company control.[42] If there is an investment banker on the board of an investment company, a majority of that board must be completely independent of *any* (not merely the particular) investment banker—a compromise of the original SEC intention to require complete divorcement of the industry and investment banking.[43] The one obvious omission from this section, a ban on interlocking directorships between investment companies and portfolio companies,[44] is the less important since Section 17 forecloses the principal contemplated abuse by regulating the sale of securities between these companies so long as the interlocking situation continues.

The foregoing requirements apply to existing as well as to newly-formed companies and will result in a big shake-up in substantial institutions such as the Lehman Corporation, for instance, all of whose directors are connected with Lehman Brothers. In most cases it was practically impossible to separate the sheep from the goats, although there is justice in the argument that investors should be permitted to invest in a company controlled by reputable bankers.[45] In a few cases it was thought feasible to provide exceptions designed to save sound existing situations not conforming to the general rule. Subsection (b) of Section 10, for instance, elaborately defines and

40. Similar restrictions apply to the "advisory board" of the investment company if one exists distinct from the board of directors [§ 10(g)], and with appropriate modifications, to the depositor of a fixed trust. § 10(f).

41. § 10(a).

42. § 10(b)(1) and (2).

43. § 10(b)(3).

44. Section 10(e) of the original draft contained such a provision but was deleted in view of the excessive disqualifications of present investment company directors which it would entail.

45. Vice-President Bunker of the Lehman Corporation, testifying before the Senate Subcommittee, argued that it was as undesirable to deprive investors of their freely chosen managements by legislative action as by sale of control, which § 16 forbids. *Hearings*, Pt. II, pp. 399, 415 *et seq.*

authorizes such a set-up as that of the two open-end trusts managed by Scudder, Stevens, and Clark as auxiliaries to their investment advisory business. No sales load is imposed, and no sales or promotional expenses are involved. Shareholders are all clients of the sponsoring firm.

While Section 10 deals with personnel, Section 17 deals generally with transactions, either forbidding or regulating "self-dealing" by members of investment company management. It is directed at a rather cruder type of peculation which has long been outlawed in the charter or by-laws of the best existing companies. It provides, with a few carefully phrased exceptions, that an affiliate or an affiliate of an affiliate of an investment company must not knowingly sell to or buy from the company.[46] The Commission may by order exempt a proposed transaction from these prohibitions, but the whole legislative history and general spirit of the Act make it evident that, for the present at least, ordinary self-dealing transactions cannot claim this exemption merely because the terms of the transaction are "fair."[47]

Complementary paragraphs of Section 17 cover other self-dealing situations than direct sale or purchase. The Commission is authorized to regulate joint transactions undertaken by an investment company and its affiliates;[48] the commissions of affiliates acting as brokers are limited;[49] and provision is made for the physical safe-keeping of the portfolio[50] and for the bonding of appropriate officials.[51]

It is a commentary upon the condition of the industry prior to this Act that Section 17 concludes by nullifying all exculpatory clauses which purport to excuse management from "wilful misfeasance, bad faith, gross negligence, or reckless disregard of the duties involved in the conduct of [their] office[!]"[52]

Capital Structure. For a variety of reasons it has been argued that investment companies have no business issuing senior securities. Such preferred stocks and bonds do not serve the economic capital-raising function of industrial issues, but more closely resemble a broker's loan to a speculating customer,[53] except that the broker retains the right to sell out the customer

46. Somewhat less strict is the National Banking Act which permits such transactions between member banks and their directors if authorized by an affirmative vote of the uninterested directors. 40 STAT. 970 (1918), 12 U. S. C. §375 (1934).

47. Private communication to the YALE LAW JOURNAL from Mr. David Schenker, director of the Investment Companies Division of the SEC.

48. §17(d).

49. §17(e).

50. §17(f).

51. §17(g). The original draft allowed the SEC to require that *any* director be bonded. Some discretion is still left, but an attempt has been made to limit it to those individuals having physical control of the portfolio.

52. §17(h) and (i).

53. It seems somewhat inconsistent to permit unrestricted borrowing by investment companies and at the same time restrict broker's loans as is done by Fed. Reserve Bd. Reg. U. (1936), issued pursuant to 48 STAT. 886 (1934), as amended by 49 STAT. 704 (1935), 15 U. S. C. §78g (Supp. 1939). Both encourage speculation in securities.

whereas the senior security-holder has no such recourse against the common stockholder who controls his money. Senior securities contradict the theory of mutuality of risk and return, which is a popular element in the investment company apologia.[54] They make pyramiding of control of other people's money possible.[55] They give a false impression of being prime liens on productive wealth, whereas the bond of an investment company is no safer than the common stocks in its portfolio — very much a junior security in the whole economic system. When issued, as has often been the case, to the extent of many times the common stock, the leverage thus created makes the common stock dangerously volatile, and tends to impose a speculative policy upon the whole company which that common stock controls.[56] And finally, though economists disagree upon the exact figures, these senior securities appear to have failed to meet the pragmatic test of earning their own keep in American investment company experience — that is, the average net cost of servicing senior securities has exceeded the average net yield of investment company assets, so that profits from capital appreciation were essential to continued solvency.[57]

Against these views the leverage companies urged the privilege of investors, if they wish, to exchange the possibility of larger returns for the security of a common stock cushion behind their senior capital. In the absence of fraud, it was said, law should not usurp the place of private business judgment. The theoretical argument was made that volatility of investment company common stock would result as surely from a speculative portfolio policy as from a high leverage ratio in the capital structure, and there was ample evidence to show that a soundly managed leverage company could be much less speculative in character than a badly managed non-leverage company.[58]

The original draft of Section 18, dealing with capital structure, would have completely banned the future issuance of senior securities, and, without

54. SEC REPORT, Pt. I, pp. 60-62; Pt. III, c. 5, p. 27.

55. See generally SEC REPORT, Pt. III, c. 4 for a running account, and SEC REPORT, Pt. II, c. 5, p. 398 *et seq.* for statistical summaries.

56. SEC REPORT, Pt. III, c. 5, p. 120.

57. American management investment companies over the period 1930-1936 earned an average annual gross current income of between 4½% and 5% of their total assets. Deducting expenses of operation and income taxes, which averaged 20% and 3% respectively of gross income, the resultant net earnings rate was not much over 3½% on the average. This rate is obviously far below the net cost of senior securities since investment companies commonly sold debentures to yield between 5% and 6% at issue price while their preferred stocks were issued at yields between 5% and 7% not counting underwriting costs. SEC REPORT, Pt. III, c. 5, p. 21.

58. Common stock stands both to gain more and lose more the greater the amount of senior capital related to it and earning a fixed return. While this leverage may be built into any corporate structure, an investment company can secure it in two ways: by purchasing leverage stocks for the portfolio, and by putting senior money into the capital structure of the company itself. The advantage of the first method is that the leverage ratio may be more easily altered to fit market conditions.

going as far as the full-fledged "death sentence" clause of the Holding Company Act,[59] would have permitted the Commission to enforce an "equitable redistribution of voting rights" in existing companies. On its face, the present section represents a considerable retreat from that position, since existing situations are left untouched,[60] and future authorization is given for closed-end companies to issue debentures to the extent of one third of their assets and preferred stock to the extent of one half their assets, provided that the total of senior securities does not exceed 50%.[61] In the case of debentures, provision must be made in the alternative for an unusually mild touch-off or for transfer of voting control to bondholders upon certain contingencies. Similar appropriate protective restrictions are imposed upon preferred stocks, and in both cases the initially established asset coverage[62] must be maintained before common dividends are declared.[63]

As a practical matter, however, and without casting aspersions on existing leverage companies through a blanket prohibition of senior securities for the future, this section has tactfully accomplished such a ban, at least for the immediate future. No closed-end companies have been organized since 1930. The preferred stocks of most, if not all, closed-end leverage companies are selling at substantial discounts below asset value on the market today.[64] Consequently, there is no strictly economic motive for attempting to sell more of such securities. And it is evident that other parts of the Act spoil the game for the predatory promoter whose motive is not sound business so much as the desire of controlling to his private advantage a large, liquid fund. In the case of open-end companies, the future issue of senior securities is explicitly forbidden, since it is obvious that, where the common shares are redeemable, so-called "senior" issues are a complete anomaly.[65]

59. 49 STAT. 820 (1935), 15 U. S. C. § 79k (Supp. 1939).

60. § 18(e).

61. Section 18(a)(1) contains the rules for debentures and § 18(a)(2) those for preferred stock.

62. "Asset coverage" of bonds means the ratio which the value of the total assets of the company, less all liabilities, and indebtedness not represented by senior securities, bears to the aggregate amount of bonds. An asset coverage of 300% on bonds must be maintained before payment of common dividends and 200% before payment of preferred dividends.

Asset coverage of preferred stock means the ratio which the value of the total assets of the company, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of bonds plus the aggregate involuntary liquidation preference of the preferred stock. An asset coverage of 200% must be maintained to allow common dividends. § 18(h).

63. In keeping with the general intent of the Act to maintain control of investment companies in the hands of those who profit directly and to avoid control by various indirectly profiting interests, companies may not issue stock warrants running over 120 days and must distribute such equally and ratably to a whole class of security holders. § 18(d).

64. REPORT, Pt. II, c. 3, pp. 112-115. *Hearings*, Pt. I, p. 273.

65. § 18(f). Lest the restrictions on creation of leverage through senior security issues be circumvented by bank borrowings, appropriate limitations on bank loans to

Dividends. The dividend section of the Act[66] underwent a like metamorphosis in the process of re-drafting and emerged in very much weaker form, though here again somewhat more power was retained than appears from a literal reading. Originally it forbade dividends upon any stock unless prescribed asset coverages were maintained for the senior securities — these ranging, at the discretion of the Commission, from a low of 150% for preferred stock to a high of 400% for debentures. In retrospect this seems a strangely rigid proposal which, in the case of companies having large unrealized capital losses, would work a hardship upon the very group it was designed to protect, by making all dividends impossible and encouraging common stockholders to speculation to recoup their position. The only alternative was to vest discretionary control of dividends in the Commission. But the exercise of a similar control under the Holding Company Act had just thrown the Associated Gas system into the wringer of reorganization and that alternative was, rightly or wrongly, regarded with suspicion.[67] At any rate, the original regulation was rejected and, no acceptable substitute being found, none was written into the final Act.

Section 19 as first drafted had also forbidden dividends from any source other than aggregate undistributed net income from interest and dividends, unless expressly authorized by the company charter or by a majority of the voting securities. This, too, has been altered to require merely that a written statement accompany dividends from any source other than net income exclusive of capital gains and losses.[68]

Although the elimination of Section 18(d) and the emasculation of Section 19 have left serious breaches in the protection which the Act offers to holders of existing senior securities, it would be a mistake to conclude that the Commission has no regulatory power over dividends. Outrageous cases, particularly those where dividends have been improperly declared upon stock owned by directors, can be punished by injunctive or criminal proceedings at the instance of the Commission.[69] And it would seem that the mere threat of such action, coupled with the power of the Commission to prescribe ac-

investment companies are contained in § 18(g) (closed-end companies) and § 18(f) (open-end companies). See also note 53 *supra.*

66. § 19.

67. In the Matter of Associated Gas & Electric Corp., Holding Company Act Release No. 1873, Jan. 10, 1940.

68. Some state corporation statutes go farther than § 19 and are specifically saved by § 50. Illinois prohibits common dividends from paid-in surplus, for instance. ILL. BUS. CORP. ACT (1933) § 41.

69. Section 36 permits the Commission to proceed in the federal courts against any member of management guilty of "gross misconduct or gross abuse of trust" and to seek a *permanent* injunction against further participation by such individual in the industry. Section 49 fixes criminal penalties, enforceable at the instance of the Attorney-General, for violation of the Act or any rule made in accordance with it. There is no such civil liability provision as appears in earlier acts, *i.e.*, Securities Act, 48 STAT. 82 (1933), as amended 48 STAT. 907 (1934), 15 U. S. C. § 77k (1934) and Holding Company Act, 49 STAT. 829 (1935), 15 U. S. C. § 79p (Supp. 1939).

counting regulations, would raise the standards of responsibility in dividend declaration.[70]

Reorganization of Investment Companies. All of the familiar abuses of voluntary corporate reorganizations[71] appeared in heightened form in the investment company field, where the stake for which the reorganizers played was a portfolio of more or less liquid assets, frequently a more desirable prize than the frozen assets of an industrial company. Almost invariably the abuses occurred where capital depreciation had wiped out the common stock equity in an investment company and left senior security holders in possession of shares whose market value was much less than actual liquidation value. Owing to the strategic position of the common stock, the preferred holders lacked legal power to compel dissolution, and could easily be induced to exchange their shares for an amount of the acquiring corporation's stock worth more on the market, but considerably less in terms of underlying assets, than the shares they gave up. When the acquiring corporation had exchanged enough stock to give it the statutory percentage for merger or dissolution, it could, by these processes, realize the full liquidation value of the stock previously acquired at a discount. There is nothing intrinsically wrong with such a scheme providing the terms of the exchange offers are fair and the eventual dissolution of the acquired company is accomplished fairly. But the record shows that high-pressure salesmanship was employed, that misrepresentations were made, that the management of the acquired company (common stockholders) were often in effect bribed to betray the preferred holders, that the proxy machinery was used unfairly, that the assets of the acquired company were unfairly valued for dissolution, and that where there was not actual fraud involved, there was often a disingenuous treatment of minority interests very close to fraud.[72] Both state and federal legislation completely failed to affect some of these reorganizations, and in the rest offered only imperfect protection.[73]

70. Adverse publicity in the newspapers resulting from mere notice of an SEC order to show cause can exert potent pressure through market reaction. Comment, *Publicity and the Security Market* (1940) 7 U. OF CHICAGO L. REV. 676.

71. SEC REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1938) Pt. VII, § 4 and Appendix B, *passim.*

72. SEC REPORT, Pt. III, § 4, p. 393 *et seq.*

73. The registration and prospectus provisions of the Securities Act of 1933 ordinarily are not applicable to reorganizations effected pursuant to typical state statutes. See note 5 to the Commission's "Rules as to the Use of Form E-1 under the Securities Act of 1933 for Securities in Reorganization" (1933). C.C.H. Securities Act Service, p. 1648, ¶ 7231 (1937).

The proxy regulations of the Securities and Exchange Act of 1934 are applicable only to corporations with securities listed on registered exchanges, which excludes over 70% of all existing investment companies controlling 40% of total investment company assets. SEC REPORT, Pt. II, c. 4, Table 1.

For the inadequacy of most state statutes to protect minority interests in voluntary reorganization, see note 72 *supra.* Furthermore the majority of these statutes fail to

Against this background the original draft of Section 25, which gave the Commission veto power over reorganization plans unless they met the bankruptcy standard of being "fair, equitable, and feasible," seemed amply justified. It would have provided an ideal laboratory experiment in the solution of a problem common to all corporate fields.

As finally re-drafted, however, Section 25 is almost meaningless, except for the possibility of the Commission's exercising an extra-statutory authority. The Section provides for full disclosure of the reorganization plan,[74] but sets no substantive standards and vests no substantive regulatory power in the Commission. Upon application by the company, or by 25% of any class of security holders, the Commission may issue an "advisory opinion."[75] The Commission may also sue to enjoin plans which are "grossly unfair," which in effect provides an alternative and possibly more competent plaintiff than the representative stockholder.[76] The unexpressed threat of such suit, together with its resulting unfavorable publicity, may not only persuade companies to apply for an advisory opinion from the Commission, but may also cause them to accept the Commission's substantive recommendations: in short, it may establish in practice what the original bill failed to establish by law.[77]

Section 11 does for open-end companies essentially what Section 25 does for the closed-enders. In this field the abuse consisted principally in high-pressuring investors out of one trust into another organized by the same promoter for the purpose of imposing new sales and service charges.[78] This abuse is met by a provision requiring SEC approval of exchange offers which are made on any other basis than the relative net asset values of the shares involved. Exchange offers within a company according to some charter or indenture provision,[79] and exchanges requiring a majority class vote are exempt.

Miscellaneous Provisions. In addition to the more general problems arising under the sections of the Act hitherto discussed, there are a number of other

cover the case of the Massachusetts business trust, a form of organization accounting for over 12% of total investment company assets. SEC REPORT, Pt. III, c. 4, p. 461.

74. § 25(a).

75. § 25(b).

76. § 25(c).

77. Since the passage of this Act (Aug. 22, 1940) the managements of three groups of investment companies have prepared reorganization plans, and in each case the company has requested, either formally or informally, the Commission's approval before submitting it to the stockholders. Communication to the YALE LAW JOURNAL from Mr. David Schenker, director of the Investment Companies Division of the SEC.

78. As many as six management companies were promoted by a single security distributing agency in one year. *Hearings,* Pt. I, p. 226.

79. The mere fact that a single company has organized several trusts under separate indentures does not bring within this exemption exchanges between them. This would seem to follow from the definition of "company" in § 2(a) which views every investment fund in the form of a trust as a distinct "issuer" and "company" for the purposes of the Act.

scattered provisions, for the most part directed at particular abuses disclosed in the SEC investigation, which will seriously affect future investment company practice.

Section 12 contains a number of these, completely unrelated. The Commission is here empowered to regulate margin purchases, short sales, and joint trading accounts in which investment companies participate.[80] It is apparently not the purpose of the Act to forbid these speculative practices entirely, provided that the company accurately describes its policy in its registration statement.[81] Subsection (b), which forbids an open-end company to distribute its own securities in contravention of SEC rules, is directed at those companies which have emphasized sales of securities rather than management by stylizing their portfolios solely from the point of view of sales-appeal, and by milking the fund in the form of promotional expenses.[82] Subsection (d) attacks pyramiding of investment companies by forbidding one company to acquire more than 5% of the stock of a concentrated investment company or more than 3% of an unconcentrated company, percentages which are harmless in terms of control.[83] If, however, a company already holds 25% of another, the Act assumes that this holding represents control or a minority interest too large to liquidate on the market, and therefore permits further acquisitions in the interest of eventual amalgamation.[84]

One serious weakness of the Act is its failure to provide any limitations on the compensation of management, or to give the Commission any jurisdiction in this regard. Section 15 deals with part of the problem by requiring investment advisory contracts, and open-end underwriting contracts to be in writing, to describe precisely the contractual compensation, to have the annual approval of directors or stockholders, to be terminable without penalty on 60 days' notice, and to be non-assignable. Previously, such contracts had

80. § 12(a).

81. This attitude was made explicit by Mr. David Schenker, now director of the Investment Companies Division of the SEC, testifying before the Senate subcommittee. *Hearings*, Pt. I, p. 233.

82. SEC REPORT, Pt. II, c. 3, p. 211 *et seq.*

83. The original draft of § 12(d) had absolutely forbidden one investment company to purchase the securities of another. But the industry, while conscious of the danger of pyramiding, felt that such purchases, purely as investments, were often desirable. The present section is a good compromise. *Cf. Statement on Investment Trusts of the Management Type by the Committee on Stock Listing of the New York Stock Exchange* (April 22, 1931). Cross or circular ownership of investment company voting securities is completely banned in § 20 as leading to fictitious valuations of the assets of all companies involved.

84. By taking advantage of § 3 [see note 22 *supra*] it is possible under the present Act to pyramid investment company control through the medium of industrial companies. Whether this will prove a serious flaw is doubtful. A last-minute attempt to close the loophole was rejected on the ground that it involved potential regulation of too many extraneous corporations. *Hearings Before a Subcommittee of the Committee on Interstate and Foreign Commerce of the House of Representatives on H. R. 10065*, 76th Cong., 3d Sess. (1940) p. 122-4.

often been a lucrative part of the promoter's "take" and remained a heavy burden upon the company.[85]

After considerable debate in hearings on the bill, a compromise was adopted with respect to the repurchase of a company's own stock. Under Section 23(c) a closed-end company may purchase on the open market after a six-month's warning to its stockholders, or pursuant to tenders by an entire class of stockholders, or under other circumstances approved by an SEC order.[86] The complicated problem of distribution and redemption of open-end company securities is turned over for trial solution for one year under Section 22 to a securities association registered under the Maloney Act.[87] After a year, if the Commission is not satisfied, it is given broad powers to deal with the problem itself.

Sections 26–29, inclusive, deal in considerable detail with the special problems of the unit trust, the periodic payment plan company, and the face-amount certificate company. While these form an important part of the general investment company picture, they are sufficiently distinct to require special study. In general, the difficulty with the unit trust is that of insuring a competent and continuous trusteeship for the "unit" of investments against which shares are issued. With the periodic payment plan companies, the problem is that which is perennially present in installment buying — fixing an equitable sales load. And for the face-amount certificate companies, which promise a fixed sum of money at a stated time, the question is largely one of maintaining adequate reserves against maturing liabilities. These problems were handled forthrightly in the Commission's original bill, which was not significantly altered in the redraft.[88]

Conclusion. In so far as the ills of the investment company industry were confined to the type of mismanagement exposed in the SEC Report, this Act could justly be termed a complete corrective. It is inconceivable that any of the old abuses should reappear. Unfortunately, however, it is not so

85. With the exception of the public utility system of companies, the investment company field is the only one where the institution of management contracts has flourished. For reasons of economy in small companies it was not possible to legislate them out of existence. But stockholders are given at least the same amount of control over managerial compensation as over directorial compensation under § 15. Contrast with the Holding Company Act which requires SEC approval as well. 49 STAT. 825 (1935), 15 U. S. C. § 79m (Supp. 1939).

86. While this section adequately protects stockholders from the unfair use of inside information to discriminate within that class, *i.e.*, by repurchasing only the shares owned by management affiliates, it is defective in its failure to provide for maintenance of the equity behind outstanding senior paper. See the suggestions for "sound investment trust practice" in N. Y. Stock Exchange statement, *supra* note 83.

87. Such associations are encouraged to take a part in the regulation of the over-the-counter market analagous to that played by organized stock exchanges in regulating exchange trading. 52 STAT. 1070 (1938), 15 U. S. C. § 78o-3 (Supp. 1939). Comment (1938) 48 YALE L. J. 633.

88. *Hearings*, Pt. IV, pp. 1119 and 1128.

easy to guarantee protection from bad business judgment as from fraud. The welfare of the individual investor in investment company securities now and always depends more upon the ability and integrity of his particular management than upon any statute.

Nor is this Act alone any guarantee of the welfare of the industry as a whole. The general problem of the service which the investment companies perform in the national economy is still open — whether they will undertake the responsibility of diverting a substantial part of their assets from the merry-go-round of the established market to the support of new industry; and, if they do, whether some reduction will be made in the excessive income tax burden which they now bear.[89]

In offering a partial answer to the first of these questions, Section 12(e) may turn out to be one of the most important provisions of the whole Act. It proposes the formation of one or more underwriting corporations, all the stock of which will be held by investment companies and which will be exempt from any inconsistent provisions of the Act, to engage in various kinds of venture capital financing. From an economic point of view the appearance of even a moderate amount of equity capital seeking investment in new industries would be extremely encouraging at the present time, and would doubtless be adequately supported by senior money from the banking system.[90] From the investment company point of view, such a cooperative scheme would mitigate the difficulties of illiquidity and supervision which have hitherto embarrassed the attempts of individual investment companies to underwrite growing industry.[91]

The tax problem is outside the scope of the Act, but it would seem that an investment company subject to the corrective provisions of the Act, fully distributing its earnings, and performing the socially useful function of furnishing and supervising venture capital to industry deserved special income tax consideration.[92] If Section 12(e) is successful and a tax adjustment is made, the social health of the industry would seem assured.[93]

89. See note 14 *supra.*

90. See Stoddard, *Small Business Wants Capital* (1940) 18 HARV. BUS. REV. 265.

91. The notable example is Goldman Sachs Trading Corp., the first, largest, and eventually least solvent company in this field. *Hearings,* Pt. I, p. 228 *et seq.*

92. Some slight beginning has been made in the establishment of a low tax rate for so-called "mutual" companies which are very narrowly defined. To qualify, the companies must be open-end, distribute 90% of their annual income, have a diversified portfolio, derive no more than a third of their income from in-and-out trading, and borrow no more than 10% of their assets. INT. REV. CODE §§ 361, 362 as amended by Revenue Act of 1940, § 3(d). These "mutual" companies, and also all "diversified" companies registered under the Investment Company Act, are exempt from the excess profits tax. SECOND REVENUE ACT of 1940, § 201.

93. Editorial, *Rounding Out the SEC,* Wall St. Journal, Sept. 23, 1938, p. 4, col. 1: "The proposed regulation of investment trusts by the SEC fills a gap in the supervision of securities which is needed. The whole idea behind the SEC has been and is, protection of the small investor; and no phase of finance is so peculiarly reserved to the small investor as the investment trust."