

The Revenue Act of

The Most Important Event in the
History of the Mutual Fund Industry



President Franklin Delano Roosevelt sails on the Sewanna with sons John, Franklin, Jr. and James during their cruise from Rockport, Maine to Campobello Island just after the President's meeting with Paul Cabot in July 1936.

By Matthew P. Fink

The year was 1935 and the leaders of the nation's investment companies were not a happy group. The country remained mired in depression and the stock market, though improving, was still well below its 1929 highs.

The predominant investment companies, closed-end funds, were the darlings of the bull market of the

1920s, when their shares traded at large premiums over the actual values of their portfolios. Now they were villains, accused by some of having caused the 1929 crash by dumping securities into a falling market. Works like John T. Flynn's *Investment Trusts Gone Wrong!* excoriated the industry. The steep decline in the stock market, exacerbated by closed-end funds' use of leverage, took a terrible toll on the value of the

funds' portfolios. Total closed-end assets plummeted from over \$2.6 billion in 1929 to \$765 million in 1932. And the funds' own shares moved from large premiums to deep discounts. From September 5, 1929 through October 5, 1932, American International Corp. fell from 84 to a low of 6, Goldman Sachs Trading Corp. from 110 to 2 ½, and U.S. & Foreign Securities Corp. from 64½ to 1%.

The smaller boys on the block, [open-end] mutual funds, introduced in 1924, also were hit hard by the bear market. Total mutual fund assets fell from \$140 million in 1929 to \$75 million in 1932. From September 30, 1929 through 1931, Massachusetts Investors Trust fell from 55 to 16, State Street Investment Corporation from 140 to 44 and Incorporated Investors from 67 to 17. But these declines were not as steep as those of closed-end funds. One reason was that, instead of trading at premiums or discounts, mutual fund shares were redeemable – a shareholder could put his or her shares back to the fund and receive a price based on the current value of the fund's portfolio.

The public was outraged by the losses they had suffered and the abuses that had been revealed. Some, like Frank A. Vanderlip, former presi-

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dent of National City Bank and author of *Tomorrow's Money*, urged that investment banks be barred from managing investment companies. Others, like Bernie Winkleman, author of *Ten Years of Wall Street*, wanted to go further and have federal law outlaw "every set-up which embraces the investment trust idea." Others, like the Senate Banking Committee, called for stringent federal regulation of investment companies. In 1935, Congress put the ball in motion when it directed the Securities and Exchange Commission to study the industry and submit recommendations to Congress. The leaders of the investment company industry could see that a major legislative battle was on the horizon.

THE REVENUE ACT OF 1936

One bright spot for investment companies was the tax area. The federal income tax law provided a 100 percent exclusion for dividends received by one corporation from another corporation. Therefore, investment companies did not pay tax on dividends they received from the corporations in which they invested.

But in June of 1935, President Franklin Delano Roosevelt proposed taxing inter-corporate dividends. In his message FDR stated that there might be an exemption for investment companies that submitted to "public regulation" and offered "small investors...the benefit of diversification."

Congress proceeded to reduce the inter-corporate dividend exclusion from 100 to 90 percent, and then to 85 percent, but did not, as FDR had mentioned, provide an exemption for investment companies. Therefore, investment companies became subject to tax on a portion of the dividends they received, and thus fund shareholders bore a tax burden that was not imposed on them if they held securities directly.

Investment companies feared that they would be taxed out of existence.

Then in March of 1936, President Roosevelt proposed an entirely new tax scheme aimed at taxing undistributed corporate profits: corporate tax rates would be increased but there would be a full deduction for dividends paid to shareholders. Corporate America and the financial community rose in vehement opposition to the proposal for fear it would pressure corporations to distribute all of their earnings.

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But, in the words of Merrill Griswold, head of Massachusetts Investors Trust, the first mutual fund, mutual fund leaders saw the President's proposal as a "godsend" that could solve their tax problem. The President's proposal would only tax undistributed profits. Since mutual funds typically paid out all of their income to shareholders, the funds would not have any tax liability. Mutual fund executives from Boston met with one of their Senators, David Walsh, who was a member of the Senate Finance Committee, to discuss a statutory exemption for mutual funds.

Then, through a stroke of pure luck, mutual fund executives met with

the President himself. In the summer of 1936, Paul Cabot, founder of State Street Investment Trust, the second mutual fund, was vacationing at his summer home in North Haven Island, Maine. Cabot spotted a yacht in the harbor that was having trouble anchoring and offered its crew a mooring. Two of the sailors turned out to be FDR's sons, who were going to join their father the next day to sail to Campobello Island. When the President arrived, Cabot secured a promise for a 10 minute meeting at the White House.

Later that summer, Cabot, Griswold and Tudor Gardiner of Incorporated Investors traveled to Washington. Just as they entered the Oval Office, the President received an urgent phone call. When the 10 minute call ended, an aide entered the room to say the meeting was over because the President's next visitor had arrived. Cabot could not contain himself and blurted out: "Mr. President, this is a damned outrage. We've come all the way down from Boston on a very important matter and we haven't had a word with you."

The President laughed and asked what the group wanted to discuss. They explained that, unlike most business leaders, they supported his proposed tax on undistributed profits. FDR was delighted and told an assistant: "Try to take care of these gentlemen."

Mutual fund leaders then met with Administration officials and members of Congress and their staffs. The result was the Revenue Act of 1936 which provided that if a mutual fund met a number of tests, the fund would be exempt from tax and fund shareholders would be taxed on distributions they receive, thus putting fund shareholders on a par with direct investors in securities.

Several of the tests were of the type one would expect to find in a tax law. The Act sought to ensure that a mutual fund would be an investment company, rather than an operating

company, by mandating that it derive at least 95 percent of its income from dividends, interest and gains on the sale of securities. To guarantee that fund shareholders would pay tax, the Act required that the fund distribute at least 90 percent of its income to shareholders as taxable dividends during the current year.

But the 1936 Act also contained tests that reflected New Deal regulatory concerns. *The Wall Street Journal* reported that “the law...seems to show what the New Deal wants in such [investment] corporations.”

As indicated in President Roosevelt’s 1935 message on inter-corporate dividends, one thing that the New Deal wanted was to provide small investors with the ability to diversify. The 1936 Act required that not more than five percent of the fund’s assets could be invested in any one corporation.

As Griswold later wrote, the New Deal also wanted to “protect investors against speculative activities.” The 1936 Act provided that not more than 30 percent of a fund’s gross income could be derived from gains from the sale of securities held for less than three months.

Finally, Griswold stated that the New Deal “wished to prevent an investment company’s acquiring control of companies in which it invested.” Therefore the 1936 Act provided that a fund could not own more than 10 percent of the stock of any corporation.

Thus through the imposition of various tests, the 1936 Act was the first federal law to regulate mutual funds’ activities, not simply in furtherance of tax policy, but also to address investor protection and economic concerns.

THE INVESTMENT COMPANY ACT OF 1940

While the mutual fund tax issue was being resolved, the SEC continued work on its study of the industry, which was completed in early 1940. On March 14, a bill of more than 100 pages drafted by the SEC was intro-

duced in both houses of Congress.

The press was unanimous in predicting that the bill was unlikely to be enacted into law, principally due to the expectation of strong industry opposition. The headline in the March 18 edition of *Barron’s* declared: “Investment Trust Law Unlikely This Year,” and the story stated: “The bill’s best chance of enactment lay in the

By 1940, the New Deal had run out of steam, the SEC was under attack, the nation was focused on American defense preparedness and even supporters of legislation believed that the SEC’s bill had gone too far.

Robert Taft, a leading Republican Senator, advised the industry to hang tough and not even to negotiate with the bill’s sponsors: “If you think you



Mutual fund leader Paul Cabot

possibility that the SEC and the investment trusts could agree on a bill which would provoke no controversy. The bill...made this possibility a thin one.” Similarly, *The New York Times* of March 24 reported that “chances of passage of the bill in this session are said to be very slight.”

Predictions grew even more pessimistic after the Senate concluded hearings. On April 27, *The Wall Street Journal’s* story began, “Enactment of legislation for federal regulation of investment trusts is no longer considered as even a fair prospect.”

It appears likely that had the industry opposed Congressional action, legislation would not have been enacted.

can sit down with those Democratic bastards and get anywhere, well you’re nuts.”

But the investment company industry surprised Senator Taft, the press and other observers and worked aggressively for the enactment of legislation.

Why did an industry that apparently could have defeated legislation subjecting its members to stringent regulation instead seek its enactment?

The explanation is fairly clear in the case of the smaller segment of the industry, mutual funds. Mutual fund leaders long had been concerned about abuses. Paul Cabot had written a landmark article on problems in the industry before the 1929 crash.

Mutual funds viewed federal regulation as a way to address abuse and restore public confidence. Mutual funds already were subject to a degree of federal regulation under the Revenue Act of 1936. Mutual funds became even more comfortable with legislation when the bill was revised to remove or modify provisions they found most objectionable, such as limits on size, segregation of management and sales functions and preventing an individual from organizing more than one fund. Massachusetts Investors Trust reported that the 1940 Act called for “very few changes in the business methods of our Company.” In short, mutual funds had much to gain, and little to lose, by enactment of the revised bill into law.

The situation of closed-end funds was more complex. On the one hand, closed-end funds, like mutual funds, wanted to end abuse and saw federal regulation as a way to restore public confidence. But on the other hand, the proposed legislation focused heavily on closed-end funds, because that was the part of the industry where most abuses had occurred. When the SEC presented its bill to Congress, an estimated 80 percent of the SEC’s testimony was devoted to closed-end funds. Weighing these factors, it is by no means clear why closed-end funds should have concluded that it was in their best interests to support legislation.

But there was an additional factor that helped lead closed-end funds to back legislation — the need for closed-end funds to become subject to “public regulation” in order to obtain special tax treatment.

Since the 1936 Act granted special tax treatment solely to mutual funds, closed-end funds found themselves at a disadvantage not only versus direct investors in securities, but also versus their long-standing rivals, mutual funds. And mutual funds, which had amounted to only five percent of investment company assets in 1929, were gaining an ever-increasing share,

growing to 25 percent in 1936 and to 40 percent in 1940.

Closed-end funds were convinced that a major factor contributing to this trend was the disparity in tax treatment. Closed-end funds concluded it was essential that they obtain special tax treatment. A closed-end witness at the Senate hearings declared: “The future tax treatment for closed-end investment trusts is most important.”

Closed-end funds realized that to obtain tax parity with mutual funds, they, like mutual funds, would have to become subject to “public regulation,” and that the 1940 Act offered a vehicle to accomplish this result. Closed-end funds adopted a two-step strategy — first regulation via enactment of the 1940 Act and then tax relief.

A closed-end witness at the Senate hearings stated: “We urge that the basis for this taxation be laid in this bill.” Similarly a closed-end witness told the House committee: “we are very hopeful that with the passage of this bill and with these companies placed under regulation the Treasury will see fit to go into this problem.”

Closed-end funds undertook a series of steps to implement their strategy. First, they put aside their rivalry with mutual funds, and the two groups formed a joint task force to work on the legislation. Second, closed-end funds obtained SEC support for their two-step approach. David Schenker, chief counsel of the SEC study, testified: “We... feel that if closed-end funds are supervised by a governmental agency...there is absolutely no reason for that [tax] discrimination.” Third, closed-end funds urged that the Senate and House committee reports accompanying the legislation spell out the need for extending special tax treatment to closed-end funds.

With both mutual funds and closed-end funds supporting legislation, the two industries acted in concert to obtain enactment. Mutual fund and closed-end witnesses testified in strong

support of reform legislation while stressing specific defects in the SEC’s bill. Next, the joint industry task force prepared a detailed outline of suggestions for legislation within the framework of the original bill. Then the SEC and the task force reached an agreement in principle that was used as the basis for a new bill supported by both the SEC and the mutual fund and closed-end industries.

Senator Downey termed these events a “miracle.” The Senate and House committees reported out the new bill which was passed by both houses. President Roosevelt signed The Investment Company Act into law on August 23, 1940. And, as closed-end funds had hoped, the next major tax law, the Revenue Act of 1942, extended special tax treatment to closed-end funds.

The Revenue Act of 1936 was the most important event in the history of the mutual fund industry: It accorded special tax treatment to mutual funds, putting fund shareholders on a par with direct investors in securities. It was also the first time the federal government subjected mutual funds to regulation in the interest of investors.

And ironically, the 1936 Act’s failure to provide special tax treatment to closed-end funds helped lead to enactment of the Investment Company Act of 1940, the federal law that governs the structure and day-to-day operations of investment companies and that has played a critical role in the industry’s success over the past 65 years. **FH**

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