into the plan in the first place. They are often buried away down deep where even the ordinarily good accountant would not find them.

Mr. REECE. I thoroughly agree, Judge, we ought to set up very careful safeguards in these reorganizations, so far as we are able to do so.

Mr. HEALY. I do not mean by what I say—I feel strongly on the subject—I agree with the Chairman that we must not get in the position where the Government seems to guarantee these values. A representation of that kind would be unlawful under the terms of section 35 of the bill.

Mr. SCHENKER. You have this added fact, that these voluntary reorganizations take place much more ferquently in the investment trust field. We have a report of four or five hundred pages which discusses the numerous instances of these voluntary reorganizations. May I go on?

The CHAIRMAN. Yes.

Mr. SCHENKER. Section 26 deals with fixed trusts. These provisions are included to make certain that a proper trustee has custody of the securities, and similar provisions.

Now, periodic payment plans are these plans whereby investment trust securities are sold on the installment plan. What we have done, in order to eliminate the abuses in that type of situation, is to fix the maximum load.

Mr. BOREN. What section are you referring to?

Mr. SCHENKER. I am referring to section 27. The problems in the periodic-payment plans are not unlike the problems in the face-amount certificate companies. The difference between the periodic-payment plan and the face-amount certificate is this: In the periodic-payment plan you ordinarily buy an investment trust security on an installment plan. Now, the company does not promise to pay you back any fixed amount of money. You get the value of your certificate as at a certain time. As the stock market goes down, the certificate is worth less, and your investment is worth less. If the stock market goes up, the value of your interest increases. What you are doing is speculating in the market on the installment plan. The face-amount certificate companies say, "We will pay you $2,500 if you pay in $10 a month for a blank number of years." The periodic-payment plans say "We will sell you an interest in the investment company's securities at the rate of $10 a month." Now, one of the deceptions practiced in the past was that they used to put a "maturity" value on the certificate which seemed to give the impression that in any event the investor would get that "maturity" value back.

Mr. BOREN. Now, in connection with the certificate which was sold to the Oklahoma school teacher, you have analyzed that. What classification does that come in?

Mr. SCHENKER. That one is a face-amount certificate.

Mr. BOREN. All right.

In connection with the point that you are discussing there, referring to the provisions of section 27 (1), on page 103, line 24, you have again reached a figure here not to exceed 9 percent.

Now, it appears to me that that might or might not be a fair figure. You no doubt arrived at it through some conclusion, but these certificates are issued anywhere for from 5 to 30 years, are they not?

Mr. SCHENKER. The average is 10 to 15 years.

Mr. BOREN. Well, there is a substantial difference between 9 percent on a certificate for 10 years and 9 percent on a certificate paid in within 15 years.

Mr. SCHENKER. But, the sale load is figured not on the period, but on the payment you make. The load cannot be more than 9 percent of the total payments that you make.

Now, those payments are spread over 20 years.

Mr. BOREN. Still they cannot be over 9 percent?

Mr. SCHENKER. They cannot be over 9 percent.

Mr. BOREN. I do not want to delay your explanation. I would like for you in the record to show some of the factors which guided you in arriving at that figure.

Mr. SCHENKER. We are submitting a memoranda showing the background of that 9 percent maximum load provision.

MEMORANDUM TO THE INTERSTATE AND FOREIGN COMMERCE COMMITTEE FROM JUDGE HEALY OF THE SECURITIES AND EXCHANGE COMMISSION, RE LOAD CHARGES (COMMISSION'S REPORT—CH. 4, COMPANIES SPONSORING INSTALLMENT INVESTMENT PLANS)

One of the major problems in the installment investment plan field arises in connection with the actual cost of the plan to the investor. Other problems concerning fees, loads, and charges find their source in the variety and types of charges and in the methods of computing and deducting them. Certain practices engaged in by sponsor companies, resulting in profits to them and increased costs to investors, are distinct aspects of the same general subject. These problems are, for the most part, unique in the investment trust industry and require a more specialized analysis than would otherwise be the case.

TYPES AND AMOUNTS OF FEES, LOADS, AND CHARGES

In the succeeding section, the amounts of the total loading charges of installment investment plans are set forth and discussed. That problem is naturally the most vital one in this subject from the standpoint of the investor. However, an adequate exposition necessitates a description of the various types of fees, loads, and charges, together with some discussion of their range and frequency.

PRIMARY SALES LOAD OR SERVICE FEES

Under most plans the sponsor company derived a substantial, if not the major, portion of its profits from the "sales load" charge on the sale of the certificate, the so-called service fee. This load or fee was deducted directly from the investor's monthly payments by the trustee and turned over to the sponsor, or retained by the sponsor in those plans in which payments were made to it. Although the typical service fee was a fixed percentage of the total amount agreed to be paid on the certificate, it was generally exacted in the first 6 or 7 months of the 10-year period of the plan. In but few plans was this load or fee spread over the entire 120 months—and in most of these instances the greater portion of the service fee was obtained by the sponsor in 12 months or less. As a consequence, only a small portion of the certificate holder's payments was actually invested for him in the underlying securities until the second or third year. (This matter is treated separately in a subsequent section in connection with particular problems raised by this manner of deducting the service fee.) Thus the early exaction of the fee by the sponsor was attended by loss of dividend-earning potentialities during the first years of the plan. More important perhaps is the problem raised by the high rate of withdrawals and defaults that occurred in the first years of the installment plan, since premature lapsing at that time was practically invariably accompanied by loss to the investor, who was entitled, not to the amount which he paid, but to the value of the underlying securities, if any, which had been purchased with the portion of his payments remaining after deduction of the sales load. In some plans the first 6 months' installment payments were retained entirely by the sponsor as its sales load, so that no portion of the investors' payments for that period was invested in the underlying securities. In those cases

the investor who withdrew from the plan at the end of 6 months received nothing back from the plan.

In this connection it must be remembered that even where the investor made payments for more than 6 months and portions of his payments were invested in the underlying securities, upon withdrawal he might not receive an amount equal to the amount which he paid in. Not only were the primary sales load and other loads and charges deducted from his payments and an amount less than that which he had paid on his certificate invested in the underlying securities but he was entitled only to the asset value of his certificate—substantially the market value of the portfolio securities underlying the security which underlay the installment-plan certificates. If the market price of these portfolio securities declined after the time of his payments, the asset value of the certificate would be less than the amount which he paid in. The market price of the portfolio securities would have to rise to an extent to equal or exceed the amount of sales load, fees, and charges deducted from the payments made by the investor, before the investor upon withdrawal would receive an amount equal to the amount which he paid on the installment certificate. If the market price of the portfolio securities continued to rise, the certificate holder would receive upon withdrawal an amount greater than the amount paid by him on his certificate up to that time.

The sponsor's sales load or "service charges" ranged from approximately $60 to $144 for the $1,200 unit. The wide variation in service fees is attributable to the fact that the sponsors of plans with low service charges derived additional profits from other types of fees. The total loading charges borne by investors, as will be seen, did not vary so widely.

The frequency distribution of this sales load or service charge for 35 comparable plans is as follows:

Amount of primary sales load:	*Number of plans*
$60 to $69	12
$70 to $79	11
$80 to $89	1
$90 to $99	5
$100 to $109	--
$110 to $119	2
$120 to $129	2
$130 to $139	1
$140 to $149	1
	35

AMOUNT OF TOTAL LOADING CHARGES

The total fees and charges borne by the installment plan investor consisted of deductions from the certificate holder's payments or from his invested funds and deductions from the distributions received on the underlying investment. Since deductions from distributions were expressed as a percentage of an indeterminate amount, they are considered separately. Some deductions from the certificate holder's principal were also variable in practice, being a percentage of the market value of the underlying fund. For purposes of comparison in this section, however, the value of the fund in these cases has been considered as having undergone neither appreciation nor depreciation. Table 5 shows the amount of the load borne by the certificate holders in 51 installment investment plans. This table discloses the amounts of initial fees, service fees and secondary loading charges, trustees' fees and the total load for each plan. The net amount invested for the certificate holder and the percentage of the total load to this amount and to the amount paid in is then presented. It appears from these figures that the average total load of all plans was 15.56 percent of the net amount to be invested if all required payments were made.

Table 6 lists the insurance costs for 28 plans offering this provision and shows how the deduction of insurance premiums affects the total net amount invested for the certificate holder. Insurance premiums were in all these cases taken out of the payments made by certificate holders, leaving the sum to be invested substantially smaller than in the noninsurance plan. While the secondary load of these plans was, therefore, slightly less in amount than that in those plans without insurance, the percentage of fees and charges to the net amount invested (not including the insurance costs) was greater. This percentage, as an average in these 28 plans, was 16.58 percent. With the insurance costs included, it amounted to 23.77 percent.

Based upon the average percentage of fees, shown by these tables the approximate fees and charges of a theoretical, average $1,200 plan without insurance amounted to approximately $160, leaving $1,040 for actual investment. A theoretical, average $1,200 plan with insurance bore a load of approximately $160 for fees and charges and $69 for insurance premiums and left $971 for actual investment.

The total loading charges for the 51 plans ranged from 7.55 percent of the net amount invested to 20.33 percent. The frequency distribution of the total loading charges for these plans is indicated in the following table:

Total loading charge (percent of amount invested):	*Number of plans*
7 to 7.9	1
8 to 8.9	—
9 to 9.9	1
10 to 10.9	7
11 to 11.9	1
12 to 12.9	4
13 to 13.9	1
14 to 14.9	4
15 to 15.9	4
16 to 16.9	7
17 to 17.9	7
18 to 18.9	6
19 to 19.9	6
20 to 20.9	2
	51

Thirty-one plans had a total loading charge that was above the average of 15.56 percent, ranging as high as 20.33 percent. Fourteen plans had total loading charges from 18 percent to 20 percent of the net amount invested.

The total load for the 28 plans having provision for insurance ranged from 8.36 percent of the net amount invested to 20.45 percent, not including the cost of insurance. The frequency distribution of these loads was as follows:

Total loading charge as of amount invested, not including cost of insurance (percent):	*Number of plans*
8.4	1
11.0 to 11.9	2
12.0 to 12.9	1
13.0 to 13.9	1
14.0 to 14.9	4
15.0 to 15.9	—
16.0 to 16.9	3
17.0 to 17.9	5
18.0 to 18.9	5
19.0 to 19.9	2
20.0 to 20.9	4
	28

Seventeen plans had a load higher than the average of 16.58 percent.

These figures, however, are not weighted with respect to the actual distribution of plans to the public. Many plans with loads much higher than the average, ranging from 17 percent to 20 percent, were those most widely sold to the public.

The fees, loads, and charges that were actually deducted in the installment plan field were larger than the theoretical or stated deductions based upon completed plans. During the period 1930–37, certificate holders in 33 plans comprising the bulk of the industry made payments aggregating $52,553,000 out of which the sponsors received $8,988,000 in primary loading charges and other fees. Only $45,540,000, consisting of certificate holders payments and net income available for reinvestment, was used to purchase underlying securities, and out of this sum secondary loading charges were paid. The sponsor's primary sales load was 20 percent of the amount used to purchase underlying securities. It is estimated that the total loading charges, including trustee's fees and secondary loading charges, were more than 30 percent of the net amount invested during this period for certificate holders.

Another consideration bearing upon the question of amount of fees and charges is the actual amount of money handled for the certificate holder during the period

of time for which the service fee, trustee fee, and other charges were made. Under the usual plan providing for the payment of $1,200 in monthly payments of $10 for a period of 10 years, the average amount of money in the hands of the trustee over the entire period would be $600. On the basis, the average net investment would be $520. The $160 average total load amounted to 30 percent of this average net investment.

Mr. COLE. Mr. Schenker, I want to go back to what I had in mind a moment ago in connection with my questions of Judge Healy and ask you about the Securities Act of 1934.

Mr. BOREN. In connection with the section we were discussing just now with regard to the periodic payment plan. I still want to call your attention to the provision on page 104. We had this Texas plan up, as an example. I do not know anything about the Texas Fund, Inc., whether it is a sound program or not, but it would not meet the requirements as laid down in this section, that is, $20.

Mr. SCHENKER. No.

Mr. BOREN. We do not want to do anything, of course, that will prevent the filling-station operator who might save $5 a month from making that saving, and yet, of course, we want to do what you have in mind at the same time.

I am just wondering if there is any other possibility.

Mr. SCHENKER. We have studied every periodic payment plan except the Texas Fund, which evidently came into existence in 1938. You will find that one of the worst blemishes on the investment industry has been the installment plans.

Now, the companies approached people to save $5 a week. The prospective purchasers feel that they can give up a couple of glasses of beer a day and save the $5 a week. Well, what happens? He pays, and pays, and pays, and then he loses his job, and defaults in a couple of payments, and then loses all of his payments for the first year as a sales load.

Mr. BOREN. Now, you have taken care of that default provision, as I understand it.

Mr. SCHENKER. Yes, sir.

Mr. BOREN. He has some return as soon as he has paid in for 4 months?

Mr. SCHENKER. That is on the face-amount certificate company.

Mr. BOREN. Why should we not put something in here on the other provisions to limit the lending period particularly on the installment payment plans? I do not see any reason for carrying on a periodic savings account beyond probably 10 years. I think that has an element of insecurity to the investor in it; letting it stretch out too long.

Mr. SCHENKER. The fact of the matter is, Congressman, that the expense of selling these certificates compelling the fellow to keep up his payments is so great, that our analysis of these plans indicates it is only in about the tenth year that the investor breaks even and only during the last 5 years of that plan that he starts making the gain. You see what I mean. We want to make these certificates safe. We do not want the companies promising a return that they cannot earn, a percentage of improvement that they cannot pay unless they will be compelled to buy third-rate mortgages and third-rate bonds.

Our analysis and the testimony of all witnesses show that when you get the payment down below $10, you are just taking the money from the investor to pay the salesman, and the investor never sees a dime of his money back.

Mr. BOREN. All right. Now, under this certificate that you analyzed here, it has no cash value for 3 years. What limitation do you put on the period that can elapse before the cash value under the periodic certificate is shown?

Mr. SCHENKER. Under this provision?

Mr. BOREN. For instance, that it shall not be more than 5 percent per year to the salesman; but you do not say that the investor shall get 5 percent back.

Mr. SCHENKER. Well, you see, the bill provides that the certificate cannot be sold if "more than one-half of any of the first twelve months the payments thereon, or their equivalent, is deducted for sales load."

Then, if you will look at page 105, there is a provision to the effect that a certificate sold, on the periodic payment plan, has to be a redeemable security. That means that he has a right to go to the company at any time to get the value of his certificate. If the company has only taken out a 50-percent load, that means that at least 50 percent has to be invested for him. Now, that amount may be, depending upon the stock market, more, or less than he paid in.

Mr. BOREN. Of course, this certificate which you analyzed comes under the open-face plan.

Mr. SCHENKER. That is right.

Mr. BOREN. I mean the face-amount plan.

Mr. SCHENKER. Yes, sir.

Mr. HEALY. I have that analysis here, Mr. Boren.

Mr. BOREN. Under this type of certificate, then he cannot provide payments for a longer period than 4 months without having a cash value; is that correct?

Mr. SCHENKER. That is correct.

Mr. BOREN. That satisfies me on that point, and it seems to me, if your interpretation of this clause just referred to is that it has the effect of having current cash value, I am willing to pass that up, and we can proceed to the face-amount certificate in connection with my other contentions.

We have the same $20 provision on it, do we not?

Mr. SCHENKER. No.

Mr. BOREN. You do not?

Mr. SCHENKER. No.

Mr. BOREN. Can they sell a face-amount certificate for as low as $5 a month?

Mr. SCHENKER. There is nothing in the bill which says that they cannot, but the set-up is such that it is virtually impossible for them to do it.

Mr. BOREN. Well, they are doing it down in Texas, are they not, under that Texas plan?

Mr. SCHENKER. Under that plan, the certificates that you gave us?

Mr. BOREN. Under that Texas plan.

Mr. SCHENKER. You mean under the Texas Fund, Inc.?

Mr. BOREN. Yes.

Mr. SCHENKER. That is a periodic and not a face-amount certificate. The fund you talk about issues a face-amount certificate, and we have been talking about periodic payment plans.

Mr. BOREN. I see. According to your analysis as set up by this bill, the Texas Fund, Inc., plan, would not be sound?

Mr. SCHENKER. That is right.

Mr. BOREN. Not fundamentally sound. I am not saying that it is not exceptional; I mean that fundamentally, companies of that class are not considered sound.

Mr. SCHENKER. We are convinced of that, and everybody in the industry is convinced of that.

Mr. BOREN. Now, on the face-amount certificate, there is no legal restriction on this face-amount certificate, but on the periodic payment certificate, there is.

Mr. SCHENKER. That is right.

Mr. BOREN. But, there is no limit on the size of the periodic payment that can be made here; is that correct?

Mr. SCHENKER. That is correct.

Mr. BOREN. But, regardless of the size, it cannot extend beyond 4 months without having some cash value?

Mr. SCHENKER. That is right.

Mr. BOREN. Very well.

Mr. SCHENKER. Do you know what the difference is, Congressman? In the periodic-payment plan there is no limitation upon the investments which the plan can make. They invest in common stocks which fluctuate up and down. They do not promise to pay you anything except the value of your certificates.

In the face-amount certificate companies, they can only invest in those securities which insurance companies invest in. Therefore, they are not subject to the same fluctuations. They promise to pay you a fixed amount at maturity, or they promise to pay you a fixed surrender value, if you surrender before that maturity.

Mr. BOREN. But your definition of the periodic-payment plan is separate from a face-amount certificate, which in itself might also be a periodic-payment certificate. Are your definitions so clear that there can be no possible confusion there?

Mr. SCHENKER. No.

Mr. BOREN. You call it an installment instead of a periodic payment, when you are dealing with the face-amount certificate, do you not?

Mr. SCHENKER. I beg your pardon.

Mr. BOREN. I say, you call it an installment instead of a periodic payment when you are dealing with the face-amount certificate?

Mr. SCHENKER. That is right.

Mr. BOREN. I have finished.

Mr. COLE. You may proceed.

Mr. SCHENKER. Now, section 30, page 123, deals with reports which are to be filed with the Commission and reports which are to be sent to stockholders.

Mr. COLE. These sections 31 and 32, are all procedural?

Mr. SCHENKER. That is right, and they have the usual provisions in them.

Section 34 deals with the destruction and falsification of reports and records.

Mr. COLE. Section 32 has two suggested amendments here; that is on page 130. There are two suggested amendments.

Mr. SCHENKER. Those two amendments were to provide for this situation: This bill provided that the accountants although selected by the board of directors in the first instance, must be submitted to the

stockholders for approval or rejection. The amendment just makes provision, in the case of the death of an accountant or his resignation, that the board of directors can fill the vacancy. Section 33 deals with settlement of lawsuits by investment companies. If a lawsuit is settled in court, the company must file the information with respect to the settlement with the Commission to study to see what the representative stockholder's problem actually is in connection with the investment companies.

Section 34 deals with the destruction and falsification of reports and records.

Section 35 deals with unlawful representations with names of investment companies and with respect to securities.

Section 36 gives permission to the Commission to institute an action to obtain an injunction to restrain any transaction which involves gross abuse of their trust or gross misconduct.

Section 37 hereafter makes it a Federal crime to steal from an investment company.

Section 38 is the usual provisions with respect to rules and regulations of the Commission.

Section 39 deals with the rules and regulations; procedure for issuance, and so forth.

Section 40 deals with hearings on orders.

Section 41 provides for public hearings.

Section 42 is the provision which gives the power to the Commission to enforce its acts.

Those have all been scrutinized very carefully by the industry and the Commission.

Sections 43, 44, 45, and 46 all pertain pretty much to well-established existing law.

Now, title II is the investment advisers' section. After the definitions, which are somewhat similar to the ones contained in title I—but, which the investment advisers wanted reprinted under this title—you have the mechanics of the registration of investment advisers. The grounds for revocation are conviction for a security fraud or injunction for a security fraud.

Then you have section 204 which provides for keeping the data on file with the Commission down to date.

Section 205.

Mr. Cole. What page is that?

Mr. Schenker. Page 164. Section 205 deals with investment advisory contracts. An important provision is that those "heads I win and tails you lose" provisions are prohibited. Also hereafter, as has happened in the past, they cannot take the investment client's account and turn it over to somebody else without his knowledge and consent.

Section 206 relates to the use of the mails to perpetrate a fraud on his clients.

Section 207 is a similar provision with respect to——

Mr. Cole. Then you have a suggested amendment to it.

Mr. Schenker. That suggested amendment was to polish up the language. What this says is that the investment adviser cannot sell securities of his client without giving him notice and/or getting his consent to the transaction. The language as originally phrased was a little bit ambiguous and we have straightened that out.