Early in 1930 this somewhat novel variety of investment scheme was conceived. It was called sometimes an installment investment plan; sometimes a periodic payment plan; sometimes a thrift plan, or a foundation plan.

These plans are all, in essence, devised for selling investment securities on a periodic or installment plan basis. These periodic payment plans should be distinguished from programs sponsored by savings banks, building and loan associations, insurance companies, and so forth.

The holder of a periodic payment plan certificate is not entitled to be repaid a fixed sum of money or a fixed amount of income, but is entitled to receive only the asset value of the certificate. This asset value is in essence based upon the market value of the securities in the portfolio of the investment company or investment trust underlying the installment investment certificate. The amount to which the certificate holder is entitled may be less than, equal to, or more than the amount paid by the certificate holder, depending upon the market price of these portfolio securities which almost invariably consist of common stocks. The purchaser of a periodic payment plan certificate, often a person of very limited means, is therefore either speculating or investing in the stock market and principally in common stocks.

The structure of the periodic payment plan in most instances, but not in every instance, as I have stated, was that of a trust on a trust, whereby two sets of sales loads were imposed upon the investors, usually without their knowledge.

The plans which were most widely sold to the public had sales loads ranging from 17 to 20 percent. The Securities and Exchange Commission, in its report to the Congress on periodic payment plans, pointed out that the total loading charges, including trustees' fees and secondary loading charges, were sometimes more than 30 percent of the net amount invested by certificate holders during the period studied. A serious problem is presented by the fact that these substantial sales loads have been usually deducted entirely from the payments made in the early months of the periodic payment plan contract. As a consequence, only a very small part of the purchaser's early payments were ever invested for his account at all, and an investor withdrawing in the first year of the plan almost inevitably received substantially less than the amount he had paid on his certificate. During the first 6 months of most of these plans a withdrawing certificate holder sustained practically a total loss. At the end of the year, this loss was well over 50 percent in many plans. Lapses of certificates in the early period of the contract have been frequent.

These periodic payment plan certificates, which were sold for as low as $5 a month, were specifically designed to make their strongest appeal to wage-earning men and women who were not in a financial position to invest or speculate in common stocks. As a result, these certificates were sold to housewives, domestic workers, laborers, nurses, stenographers, clerks, and others who had little financial experience. Inasmuch as the refinement and technique of the operation of periodic payment plans are intricate, they were far beyond the comprehension of the class of persons to whom these certificates were sold.

In addition we found that persons unqualified to understand the intricacies of the plan were often employed to sell them. Further it was found that sometimes the salesman who did understand them misrepresented them. Some of them misrepresented them without knowing any better. Fees were minimized or were not disclosed. Undue emphasis was placed on trustees and the trusteeship. The trustee was often a very respectable trust company or bank whose functions were usually confined merely to holding the title or custody of the underlying securities. The salesmen would sometimes show the balance sheets of these banks to the prospects who would be advised that the trustee was back of and sponsored the plan and thus subscribers to these plans were led into the misapprehension that these large financial institutions actually guaranteed the so-called maturity value of the plans.

A few words more about the face-amount installment certificates. As I have tried to indicate, the face-amount installment securities are in essence unsecured obligations to pay a specified amount to the holder at a specified future date, provided the purchaser makes all of the payments required by these contracts. The contracts, after a certain number of prescribed payments, have a cash surrender value, that is, the holder of the contract is entitled to receive prior to maturity a specified amount if he surrenders his certificate to the issuing company.

The face amounts of these certificates are usually $2,500 or less, with payments in instalments over a period of 10 or 15 years, varying according to series. A typical certificate issued by these companies has a face amount of $2,500 and requires payments in instalments over a period of 15 years of $1,800, or $120 per year. The strength of the appeal of these certificates to investors is indicated by the fact that at the end of 1936 such investors had contracted to invest some $700,000,000 in these companies and had already paid in about $100,000,000 on these obligations.

Many instances have been disclosed where this type of security has been sold on the basis of the comparison with savings bank deposits and insurance policies. Although savings banks and insurance companies are subject to strict regulation as to assets and reserves, the face-amount certificate companies have operated without any such uniform type of regulation, with the result that, in some cases, assets have been carried at highly fictitious values and, in other cases, inadequate reserves have been maintained for the fixed obligations, that is, they were inadequate to insure, absolutely insure, the payment of the certificates at maturity at the face amount.

The Commission's study has indicated that in certain cases the obligations of face-amount companies with high improvement rates—the difference between what you pay and what you are supposed to get back—are the so-called improvement rates—have been met, despite changed conditions with lower prevailing interest returns on investments, and that this has come about through a combination of several factors which I shall try to describe.

The lapse experience of investors was high. That is, they started contracts, made some payments, and then had to quit. This lapse experience was particularly high during the first and second years when the contract had no surrender value or a surrender value of substantially less than the total of the amount he had paid.

It is fair to add, however, that the certificates issued by some of the face-amount companies provided for reinstatement with credit for the amount paid in. Then there was the so-called stretch-out practice, which was this, that is, the investor was deprived of any interest return on his entire investment during any time that he was in default; that is, no matter how much he paid, if he missed an installment during that period he did not get any interest during that period, not even on what he had already paid in. And, that of course lowered the improvement rate so far as the company was concerned.

Furthermore, surrender values only accrued as of anniversary dates of the certificates, which was yearly. Monthly payments less than a year and interest on the last attained surrender value would not increase the surrender value above the preceding anniversary date. Payments made and interest on the entire investment between anniversary dates, therefore, might be sacrificed under the terms of the contract in the event of any surrender between such dates.

As a result of the various types of regulatory provisions in the many States in which face-amount companies operate, there is presently no uniform actuarial reserve system required by law.

Another serious aspect of this type of investment company relates to the problems of the investors in these certificates in the event of the bankruptcy of such a company. Not all of these companies are at present required to deposit qualified assets with any custodian for the benefit of all their certificate holders. However, some State authorities do require such deposits for the protection of certificate holders residing in the particular States and even such requirements are not on a uniform basis. In the event of bankruptcy, a situation might be created where inequality of treatment might exist for certificate holders of the various States. Furthermore the problems arising out of bankruptcy would be accentuated by the fact that the assets of these companies are located in almost every State in the country.

I have tried to compress into a short period as much as I could tell you of the investigation and some of the results and conclusions that came out of it; but I would like to go for a few minutes longer and say something about the hearings before the Senate subcommittee.

We went up to the subcommittee and put ourselves on record in favor of the original bill. The bill as conceived by the Commission had been somewhat modified in advance of those hearings, as the result of discussions with various representatives of the industry. The Senate subcommittee heard us for about 2 weeks. We went into considerable detail. Here I have had time only to sketch the problems. Many of the items that I have passed over rather lightly, we thought best to spell out and try to prove, and so we called quite a number of witnesses. At the end of that period the subcommittee thought that we ought to quit. We were prepared to go on with some further evidence, but the committee thought that they would like to hear the industry at that time. So then the industry went ahead and presented their views.

Out of all those who appeared there, there was only one who said there ought not to be regulation. I understand that he has since endorsed the bill now pending before this committee.

At the end of the hearings, Mr. Bunker, who had been one of the representatives of the industry and had spoken before the committee, asked leave to address the subcommittee. Thereupon this is what happened: The industry, as I have stated, had spoken in favor of regulation, and Mr. Bunker reaffirmed that position The industry had criticized various provisions of the bill. He still criticized some of them, but he did not stop there. He did not make the mistake which I submit some other industries that have come before Congress have made, of not submitting constructive suggestions of their own as to how to deal with particular situations which were evil and were admitted to be evil. He offered some constructive suggestions. I was not in accord with everything he said, but I recognized that his suggestions were honest ones; that they were made in good faith, and that they were honestly constructive; they were not just make-believe or anything like it. I congratulated Mr. Bunker on the position he had taken.

With the blessings of the Senate committee, I discussed the situation with my associates in the investment trust study, the members of the staff, and I discussed it with by brother Commissioners, and with their full approval we sat down with the representatives of the industry to see if we could get to a point where we could go back to the Senate subcommittee and say "Here are recommendations upon which we and the industry are in full agreement."

Our hearings began in the Senate the 2d day of April and ended on the last Friday of April, except for some rather informal discussions that took place later. From the 2d of April down to not so many days ago, Mr. Schenker and Mr. Hollands of my staff, with occasional consultations with me and consultations with representatives of the industry, notably Mr. Jaretzki, representing the closed-end companies, and Mr. Motley, representing the open-end companies, and Judge Norton representing one of the largest face-amount certificate companies, have worked day and night, Sundays and holidays, for nearly 5 weeks. Finally we were able to go to the subcommittee and present a memorandum and say, "We are all in agreement on this."

The subcommittee looked it over and suggested we than try to translate those principles into a bill. Of course, that was quite difficult. It was much easier to state principles in a memorandum than it was to state them in a bill; but it was finally done. The bill was laid on the desk of the subcommittee of the Senate with the statement that practically the whole industry and the Commission were in accord in backing up those recommendations.

After some consideration and some questioning, the subcommittee over there reported it out favorably to the Senate by a vote of 14 to 1.

Now, that is substantially the bill that is before this subcommittee.

I do not want to cut our presentation short in the least degree or to fail to open up any aspect of it that the committee wishes to hear about. I hope I do not make myself offensive if I say that the fact that the Commission, after 4 years' study of the subject, and the leaders of the industry, have been able to agree on a joint recommendation, ought to raise at least some presumption in favor of the bill. That is not, however, to make the slightest inroads upon the obligations and duties of this subcommittee. This is the lawmaking body. We are not; and the industry is not.

If I may make a brief reference off the record.

(Off the record.)

We think that the bill is in the public interest and we think that it is in the interest of the industry.

Mr. COLE. Judge, in your statement, will you incorporate in full the language of section 30 of the Holding Company Act?

Mr. HEALY. Yes; I will be glad to.

Mr. COLE. Briefly, will you explain to the committee just why it is that through publicity and the other provisions of the Securities Act of 1933, and the Securities and Exchange Act of 1934, some of the abuses complained of in connection with this bill cannot be reached?

Mr. HEALY. Yes, sir; I will try to. Let me comply with your first request first.

Mr. BOREN. Could you not insert that in the record?

Mr. COLE. What is that?

Mr. BOREN. Could he not insert that rather than read it?

Mr. COLE. Yes; just have it made a part of the record.

(Section 30 above referred to is as follows:)

SEC. 30. The Commission is authorized and directed to make studies and investigations of public-utility companies, the territories served or which can be served by public-utility companies, and the manner in which the same are or can be served, to determine the sizes, types, and locations of public-utility companies which do or can operate most economically and efficiently in the public interest, in the interest of investors and consumers, and in furtherance of a wider and more economical use of gas and electric energy; upon the basis of such investigation and studies the Commission shall make public from time to time its recommendations as to the type and size of geographically and economically integrated public-utility systems which, having regard for the nature and character of the locality served, can best promote and harmonize the interests of the public, the investor, and the consumer. The Commission is authorized and directed to make a study of the functions and activities of investment trusts and investment companies, the corporate structures, and investment policies of such trusts and companies, the influence exerted by such trusts and companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies, and to report the results of its study and its recommendations to the Congress on or before January 4, 1937.

Mr. HEALY. In answer to your question, as to why the '33 Act and the '34 Act have not reached the abuses, one of the principal reasons is that most of these trusts have not registered under either of those acts. The face-amount certificate plans escaped registration, and only a limited number of any of them have registered on the stock exchanges.

Mr. COLE. The face amount; that is the type where you illustrated a little while ago they issued a $2,500 certificate, and the purchaser paid in about $1,800 over a period of 15 or 18 years.

Mr. HEALY. Yes, sir.

Mr. COLE. All right.

Mr. HEALY. Furthermore, during the period that the Securities Act has been in effect, since 1933, some of the worst abuses have occurred.

The Securities Act and the Securities and Exchange Act provide no regulation whatever of these investment trusts. They are simply required to make disclosure. The pending measure is a regulatory measure. It undertakes to regulate certain practices and to stop certain things. And, the Securities Act undertakes no such results. Under the Securities Act if a man makes a complete disclosure, he can do anything, almost, that he pleases; but there are certain practices that have happened in connection with investment companies that I think everybody agrees—I think certainly everybody in the industry I have talked with agrees—ought to be stopped, and they cannot be stopped by mere disclosure.

I am not alone in this view. With your permission, I would like to quote from an editorial in the New York Times of November 12, 1936:

Many investment trust officers would stop here (that is, publicity), holding that "bright sunlight" is all that is needed, and that once this is brought to bear on trust affairs the investor himself must make his choice. But the experience of the last decade indicates that more than this is needed.

* * * * * * *

Among the principal abuses of investment trusts have been their use as dumping grounds for unmarketable underwritings participated in by the banking house controlling the trusts; the too rapid turning over of their portfolios (often with the object of obtaining commissions for the banking house); a complicated financial structure; the acquisition of highly speculative instead of sound dividend-paying stocks; and the excessive concentration of investments in one or a few companies. Most of these abuses would not be difficult to correct. There are also other practices the wisdom of which, on grounds of public policy, is at least open to debate. These include, for example, the purchase of so large an amount of the stock of particular companies that the trust has a dominating voice in the management of those companies. Investment trusts, in any case, are as properly subject to regulation as savings banks and insurance companies. Such regulation has been long overdue.

This editorial which sort of epitomizes some of those that I tried to describe, cannot be handled, in my opinion, except by regulation. I think that the best men in the industry are of the same opinion.

Mr. BOREN. Mr. Chairman.

Mr. COLE. Mr. Boren.

Mr. BOREN. In the definition of public offering, I presume that that definition covers any sale to anyone in the public, whether it is listed on or off any exchange.

Mr. HEALEY. The problem of whether it is a public offering does not depend upon whether it is on or off of the exchange, in my opinion. It depends upon the method of offering: That is, if you make an offering to 10 people in a circle of friends, obviously, that is a private offering. If you put an advertisement in the newspaper and send out salesmen and succeed in selling your securities to a large number, that is a public offering. It may be a public offering when, although you offer to many thousands of people, you succeed in selling only to a small number.

Mr. BOREN. What size corporation would come under this regulation? Is there any limitation on the size coming under this act?

Mr. HEALY. There is this kind of a provision, if anybody wants to start a new trust, he has got to have at least $250,000 capital.

Mr. BOREN. $100,000, if I read the explanation correctly.

Mr. HEALY. I am wrong about that figure. It is $100,000 for an ordinary trust and $250,000 for a face-amount.

Mr. BOREN. Well, now, do you mean that no one can start a new company who does not have more than $100,000 or have at least $100,000 to start out with? Do you interpret this bill to mean that it would take in all that exist at the present time, even one which had a capital stock of $10,000, perhaps?

Mr. HEALY. Well, I think it would. Will you give me just a minute? I would like to talk with my associate.

I do not think that there are any companies in that position, but I do not remember that the bill says that a company below a certain size is exempt, if that answers your question.

Mr. BOREN. Now, following that question as to the size of it, the size of the issue, would that have anything to do with the regulation which I have just referred to?

Mr. HEALY. I cannot think of any.

Mr. BOREN. Whether the issued securities had a face-value that you referred to a while ago of a thousand dollars, or a million dollars, it does not make any difference whether or not that is their size, they come under this bill?

Mr. HEALY. I think that is correct.

Mr. BOREN. At the present time, a company organized under the state laws of some State, with $50,000 or $100,000 capitalization, selling securities as you have defined at length there, under that investment plan, if they were incorporated under the laws of a given State and presumably were operating within the State, yet using the mails and other instruments of interstate commerce, which are designed as a part of the interstate commerce instrumentalities, would they come under this regulation?

Mr. HEALY. As I understand it, they would.

Mr. BOREN. I was particularly interested in your discussion of the installment plan buying of certificates, and it just so happens that I have a concrete example of such certificate which was sold to a school teacher in Oklahoma. This certificate which I have referred to requires that 110 percent of the liability on the certificate must be at all times available in certain defined assets, which assets, I presume, are a sufficient guarantee to the security of that amount of money. Of course the joker in it is that the 110 percent of liability—this word "liability"—the liability is very small in comparison with the amount of money paid in. For example, according to this record there was exactly $200 paid in on this $2,200 certificate, and there is not one cent of liability, yet. So, I take it that this $200 could have been completely spent and the contract in no way violated, more than that the liability is not reached until 36 months of payments have been made, and then the liability is $69, and so on up the line.

Mr. HEALY. The actual payments, of course, at that period would have been much in excess of the $69.

Mr. BOREN. Now there is a question which has occurred to my mind, which is evidenced by this certificate. The clause says that the certificate will be forfeited if at any time payments lapse beyond a 2-year period. It provides in there for certain methods of keeping the certificate alive by extending the maturity value and canceling all interest increment on the certificate if irregular payments are made even, say, one every 6 months or even one in 2 years; but I notice in the record of this certificate that there is one time in the receipt of payments when a period elapsed of more than 2 years. Here is one payment, January 26, 1935; the next payment is September 9, 1937.

Now, I just wondered if in a case of that character under the present situation, if the second payment was not in itself illegal within the contract. The contract itself says that where 2 years have elapsed the certificate is forfeited.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION

Mr. SCHENKER. Mr. Chairman, my name is David Schenker. I am counsel for the investment-trust studies, and I participated in the investigation of the type of companies that the Congressman referred to, namely, the face-amount companies, and I am thoroughly familiar with the situation. My opinion, Congressman, is that one of the most salutary effects of this proposed legislation is to clean up that type of company that you are talking about.

Now, that certificate you have there is one that falls into the category of a face-amount certificate, and that 2-year provision you talk about is what Judge Healy referred to as stretch-outs.

Now, if you pay for 14 years and pay regularly, and you default on one single $10 payment, that stops your interest an all of the money that you have paid in for the 14 years.

That 2-year period means that they can keep that up for 2 years; but after the 2 years the stretch-out right stops and then they have to issue you what they call a paid-up certificate, which is a new certificate, which represents the amount of money that you paid in less the improvement rate for the period that you were in default for a $10 payment. This bill cures that situation.

Mr. BOREN. Pursuing that line of thought just a little further: The particular certificate has no cash or loan value until 36 payments have been made.

Mr. SCHENKER. We have taken care of that too, Congressman.

Mr. BOREN. Now, in this particular instance, the owner of the certificate has paid a total of $200 which is about the equivalent of, I take it, 2 years' payments. She cannot, even if she had paid 35 months, she still could not get one cent back without paying in an additional amount to qualify it for the $69 cash value or, as in this case, she has $200 invested. She would probably have to pay another $100 in order to guarantee getting back the $69.

Now, arriving at what I have in mind, I do not mind saying it on the record, that I am thoroughly convinced that something ought to be done to correct the sale of this sort of contract to people who in themselves are not capable of ascertaining readily the amount of cash assets, available assets behind the certificate that they purchase. But, continuing with the point, I cannot understand why you have produced a bill here which automatically takes this company into its control, which probably has a total capital of $50,000 or $100,000. I do not know what it is. You automatically take it into control and yet you place in here restrictions that, despite the fact that there are a thousand companies like this which have originated with less money than that, now no company can originate under the specified amount of assets provided for in this bill. I do not see the logic of that.

Mr. HEALY. They can get that amount of assets to start with, if they can gather them together within their own group, who wish to promote such a company; but this——

Mr. BOREN. What value is that to regulation?

Mr. HEALY. Let me explain. This kind of a contract, this so-called face-amount certificate—it is just an evidence of indebtedness. I pay over some money to the corporation, and the corporation agrees that at a certain date it will pay back to me so much.

Mr. BOREN. Is that by the time I have paid in approximately $300, they would guarantee to invest in Government bonds a sum similar to or at least $70 of that $300? That is what this says.

Mr. HEALY. I think the essential point there is whether they will carry out the contract. They have simply agreed to pay me on a certain date a certain sum of money if I do a certain thing. It is simply evidence of indebtedness.

When you find a corporation that has $120,000,000 of assets and has $2,000,000 worth of stock, I submit that what actually has happened is that a $2,000,000 corporation has borrowed $118,000,000 from the public.

I submit that corporation should not be allowed or encouraged to do that sort of thing unless there is a substantial investment in the company.

If you require these payments——

Mr. BOREN (interposing). Still, Judge, if you will permit another interruption.

Mr. HEALY. Yes, sir.

Mr. BOREN. Still, you would not let a company issue $2,000,000 of stock to participate in dividends of only $100,000, would you?

Mr. HEALY. I do not understand your question.

Mr. BOREN. You only require $100,000 here. Could that $100,000 company issue $2,000,000 worth of stock?

Mr. HEALY. No, sir.

Mr. BOREN. That, it seems to me, is out of balance.

Mr. HEALY. That is, it can solicit; it can sell public subscriptions. If it is a face-amount company, then it will have to start off with at least $250,000 capital provided by the promoters; but once they get under way, having gotten their original subscriptions of $250,000, the bill, as I understand it, does not impose any limitation upon the amount that they can sell; but it does undertake to surround that kind of a company with certain restrictions and safeguards. For example: There are other restrictions on the payment of dividends; there are rather strict provisions on the subject of creating reserves. Referring to that very contract you read from a moment ago I would like to ask two questions. I have not seen the contract. The legal question you asked me I cannot possibly answer without studying the contract; but is there in that contract any proviso as to the assets that you referred to that are supposed to be back of it? Is there in the contract anything that indicates that those securities the investor put his money into those securities that are supposed to be back to that certificate are in the hands of any trust company or anybody except the corporation itself?

Mr. BOREN. No.

Mr. HEALY. If your implied criticism or suggestion is valid, then it seems that the logical answer would be that perhaps the bill does not go far enough.

Mr. BOREN. My impression here is that it seems more logical to me to set some percentage or sliding scale of regulation to reach the problem you have in mind than to arbitrarily arrive at $100,000 in the proviso.

Mr. HEALY. Do you mean by that that you would keep for the face-amount companies, keep the amount of certificates issued in some relationshi͏p to the stock?

Mr. BOREN. Relationship to the capital.

Mr. HEALY. Or to the capital?

Mr. BOREN. Yes.

Mr. HEALY. But that is pretty well taken care of by the reserve requirement and by custodial requirements that have been written into the new bill. The securities they invest in will have to go into custody, a reserve will have to be established, so that under those