The other amendment under section 208 was really a change in draftsmanship. You cannot hold yourself out as an investment counselor unless you are engaged in the investment counselor business.

Section 209 is an enforcement provision.

The only other provision of consequence is section 210, which in our opinion will have a very salutary effect. The investment counsels were a little concerned about the effect on their business if it got around that the Securities and Exchange Commission was conducting an investigation. In order to safeguard against this danger section 210 (a) and (b) provide that there shall not be any disclosure of any investigation by the Securities and Exchange Commission until it has made up its mind that a public hearing is to be held. Then in order to safeguard them further, subsection (c), provides that the Commission cannot ask these investment counsellors to disclose their clients, and what their investments are, except if there is some indication of wrongdoing. Thereafter, in connection with the investigation, they have to make the disclosure.

These provisions give them assurance that wherever possible their rights in connection with publicity and penalties are preserved.

Then, section 212 provides for hearings.

Section 213 provides for court review of orders.

Section 214 covers jurisdiction of offenses and suits.

Section 215 covers the validity of contracts.

Section 216 the annual reports of the Commission.

Mr. REECE. What is the attitude of the investment counsellors generally with respect to the bill; is it favorable or unfavorable?

Mr. SCHENKER. The investment counselors including, Mr. White and Mr. Rose, appeared yesterday.

Mr. REECE. Yes; I was here when Mr. White appeared. Is he their general representative?

Mr. SCHENKER. Dwight Rose represents the association. And, I have been in touch, in the course of the investigations and studies which we have made, with a great number of investment counselors. I think it is correct to say that most all the investment counselors are for the bill.

You also have this problem: There are investment bankers who perform or do investment counselor business. They are subject already to a similar type of registration and regulation as brokers and dealers. They did not appear in opposition to the bill.

Furthermore we were in constant touch with the National Association of Security Dealers who have an investment counsel committee studying this bill. They were up at the Commission offices only the other day and cleared the investment counsel section.

Mr. HOLLANDS. Mr. Chairman, I will put into the record now with your permission, this memorandum relating to the telegram from the Texas Fund, Inc.

Mr. COLE. Yes. That is the subject to which I referred earlier?

Mr. HOLLANDS. This telegram supplements the letter of yesterday. I do not know whether you want to read that or not.

Mr. SCHENKER. We have a memorandum on that subject which we want to introduce.

Mr. COLE. This telegram and letter may be entered in the record.

(The telegram and letter referred to are as follows:)

DALLAS, TEX., *June 13, 1940.*

Hon. WILLIAM P. COLE, JR.,
Chairman, Subcommittee Interstate and Foreign Commerce Committee of House, Washington, D. C.:

Supplementing our letter of June 12, 1940, to you we respectfully urge that a similar provision to that of section 3 (a) 11 of the Securities Act of 1933 be incorporated in pending Investment Trust Act. This would exempt companies organized under laws of a State and selling its securities solely to residents of such State. Such companies should not be considered within the findings as to effect on interstate commerce contained in section 1 of pending act. To include them is in our view a clear invasion of the rights of States to the regulation of matters originated and consummated entirely within their borders particularly where such States provide adequate supervision by their own security divisions.

The mere fact that such companies use the United States mail has never been considered alone as a ground for Federal control. Practically every business in the United States, whether interstate or intrastate, uses the mail. Congress evidently recognized this principle in the Securities Act of 1933 by the inclusion of the above-mentioned exemption.

THE TEXAS FUND, INC.,
LOGAN FORD, *Vice President.*

MEMORANDUM RE TEXAS FUND, INC.—SALES OF PERIODIC PAYMENT PLAN CERTIFICATES LIMITED TO A SINGLE STATE

A telegram from Texas Fund, Inc., dated June 13, 1940, reads as follows:

"Referring further to investment trust bill now before subcommittee of House we respectfully urge that a similar provision to section 3 (11) of Securities Act of 1933 be incorporated in pending investment trust act. This would exempt companies organized under the laws of a State selling a security solely to residents of such State. Such company should not be considered within the findings as to affect interstate commerce contained in section I of pending act. Clear invasion of the rights of States to the regulation of matters originated and consummated entirely within their borders, particularly where such States provide adequate supervision by its own securities division. The mere fact that such companies use the mails has never been considered alone as a ground for Federal control. Practically every business in the United States, whether interstate or intrastate, uses the mails. Congress evidently recognizes this principle in the Securities Act of 1933 by the inclusion of the above mentioned exemption."

The telegram constitutes in effect an argument that H. R. 10065 is unconstitutional as applied to Texas Fund, Inc. For the reasons hereinafter given, the Securities and Exchange Commission is unable to agree with this conclusion.

OPERATION OF H. R. 10065 AS APPLIED TO TEXAS FUND, INC.

The principal provision of the bill applicable to companies selling periodic payment plan certificates is section 27. A letter from the company to Chairman Cole of the subcommittee, dated June 12, 1940, indicates that it is particularly concerned with the minimum payments required by paragraph (4) of subsection (a) of this section.

The provisions of section 27 apply only to companies registered under section 8 of the bill. Such registration is required, under certain circumstances, by section 7.

While the facts are not entirely clear from the company's statements, its letter of June 12 indicates that the corporation (Texas Fund, Inc.) is only the depositor or underwriter of certificates representing an undivided interest in a semifixed or unit investment trust. On this assumption the unit trust, considered as an entity, and not the corporation, is the "issuer" of the certificates within the meaning of the bill (see secs. 2 (a) (8), (21), and (27)), and section 7 (b), rather than section 7 (a), is the applicable provision requiring registration. Under section 7 (b) it is necessary for the trust to register if its depositor, trustee, or underwriter sells or redeems its certificates by use of the mails or means or instrumentalities of interstate commerce, or if securities are purchased or sold for the portfolio of the trust by use of the mails or means or instrumentalities of interstate commerce.

The fact that certificates may be sold only to residents of Texas is not wholly inconsistent with the use of instrumentalities of interstate commerce in their sale, though it is of course true that a resident of the State will ordinarily be within

the borders of the State at the time he purchases a certificate. In any event, *redemption* by the use of instrumentalities of interstate commerce is not prevented by a limitation of *sales* to residents of the State: nothing in the company's statements indicates that certificates sold to residents may not later be transferred by the holders to nonresidents and redeemed from the transferees. Most important of all, it is clear that in making up new units of stock for the portfolio of the trust, or in selling units in order to obtain cash for redemptions, the facilities of an extrastate national securities exchange will be employed. The entire portfolio of the trust, according to the company's letter of June 12, is made up of shares of 30 common stocks listed on the New York Stock Exchange. The term "means or instrumentality of interstate commerce" includes any facility of a national securities exchange (sec. 2 (a) (24)).

Moreover, it may fairly be assumed that the mails are used in all these activities.

For the foregoing reasons, registration of the trust will be required by section 7 (b), and section 27 will then be applicable.

As so applied, the bill is constitutional.—To the extent that the company sells or redeems securities of the trust by transactions which cross State lines, it is obvious that the Congress has full regulatory powers. The same considerations apply to sales and purchases of securities for its portfolio. The interstate character of its portfolio transactions are doubly apparent: First, because the trustee of the trust is located in Texas and all of its portfolio securities are listed on the New York Stock Exchange, so that whenever purchases or sales are made for the portfolio the order will be transmitted through a Texas broker or the Texas office of a member of the New York Stock Exchange to the New York office of a member of that exchange, crossing many State lines in the process; and second, because even intrastate transactions on a national-securities exchange so directly and substantially affect interstate commerce as to be within the scope of Federal power. The latter proposition is supported by the decisions of the Supreme Court upholding Federal regulation of commodities exchanges. See *Chicago Board of Trade* v. *Olsen* (262 U. S. 1). There has been consistent recognition of the proposition that transactions, though effected locally, are subject to Federal regulation if they are part of the flow of, or affect, or if their regulation will remove burdens from interstate commerce (*Tagg Brothers and Marehead* v. *United States*, 280 U. S. 420; *United States* v. *Joint Traffic Association*, 171 U. S. 505).

The proposition is sustained even more pointedly by the Securities Exchange Act of 1934, which is generally predicated on the theory that stock exchanges are instrumentalities of interstate commerce. The latter act, it may be pointed out, was not only passed by Congress and approved by the President after due consideration of questions of constitutionality, but has not been successfully attacked on constitutional grounds in any court during the 6 years since its enactment.

Even if the foregoing bases for Federal legislation were not adequate in themselves, it is apparent that a trust of the type sponsored by Texas Fund, Inc., must be regulated under the proposed legislation if it is not to be given an unfair competitive advantage over those trusts which carry on all their operations in a number of States. Because of the very serious abuses peculiar to periodic payment plans, section 27 (a) limits the sales load on their certificates. Companies operating on a national scale would be placed in a hopeless competitive situation if their sales load were limited and if the sales load of companies confining their activities to the residents of a single State were not subject to similar restrictions. The Securities and Exchange Commission's reports show that competition does not provide its own cure in such a situation, since by increasing the sales load high pressure sales methods can be made so profitable that they are almost certain to be employed by salesmen, to the great detriment of the exceptionally unsophisticated class of investors who purchase a large proportion of periodic payment plan certificates. It is a well established principle of constitutional interpretation, stemming from the *Shreveport Case* (234 U. S. 342) and the *Minnesota Rate Cases* (230 U. S. 352), that intrastate activities which so directly impinge upon interstate activities as seriously as to impair the effectiveness and fairness of regulation of the latter are themselves regulable by the Congress under the commerce clause.

In pursuance of this doctrine it has not been regarded as necessary to the exercise of Federal power that the precise activity regulated itself involve interstate commerce (*N. L. R. B.* v. *Fainblatt*, 306 U. S. 601; *I. C. C.* v. *Goodrich Transit Corp.*, 224 U. S. 194; *N. L. R. B.* v. *Jones & Laughlin Steel Co.*, 301 U. S. 1). Sales and redemptions made by Texas Fund, Inc., even though made to and from residents of Texas, have a direct effect on interstate sales made by other companies and are an integral part of a process of portfolio accumulation and turn-over which inevitably affects and involves interstate commerce and use of

its facilities. These sales and redemptions can clearly be regulated by Congress (*Stafford* v. *Wallace*, 258 U. S. 496; *N. L. R. B.* v. *Jones & McLaughlin Steel Co.*, (supra)). There is no substance in the Fund's argument that such regulation is a "clear invasion of the rights of States to the regulation of matters originated and consummated entirely within their borders * * *."

Finally, Federal legislation may be based upon the use of the mails. It is not true, as the company states, that "the mere fact that such companies use the mails has never been considered alone as a ground for Federal control." Statutes now administered by the Securities and Exchange Commission are based upon the use of the mails *or* means or instrumentalities of interstate commerce. For the scope of the mail power, see *Ex parte Jackson* (96 U. S. 727); *Public Clearing House* v. *Coyne* (194 U. S. 497); *Badders* v. *United States* (240 U. S. 391).

The Congress has proprietary power over the mails—and the exercise of this power to "forbid any such acts done in furtherance of a scheme that it regards as contrary to public policy, *whether it can forbid the scheme or not*"[italics added] has clear constitutional sanction. (*Badders* v. *United States* (supra) 393; *Lewis Publishing Co.* v. *Morgan*, 229 U. S. 288; see too, *Burco, Inc.* v. *Whitworth*, 81 F. (2d) 721, (C. C. A. 4th, 1936), cert. den., 297 U. S. 724, at 739.)

The arguments of Texas Fund, Inc., are based upon a misconception of section 3 (a) (11) of the Securities Act of 1933.—Section 3 (a) (11) of the Secruities Act of 1933 grants an exemption to—

"Any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within such State or Territory."

Section 3 (a) (11) of the Securities Act was obviously not included in the act for constitutional reasons. A local distribution by a local corporation to local residents is exempted by the act from the requirement that a registration statement be filed. The same distribution is, however, not exempted from the provisions prohibiting fraud and false and misleading statements. Thus, it is clear that Congress had the power to regulate and did regulate such local distributions. It preferred, however, not to require registration but only to prohibit fraud. This it did because it believed that in the case of the ordinary business corporation, local residents would be sufficiently familiar with the business so that in most cases adequate disclosure could be obtained without registration.

However, in the present case, as has been noted above, local investment companies, particularly of the type of Texas Fund, Inc., are not local business concerns as ordinarily understood. They are companies whose main business is the sale of securities to the public and who are selling their securities in direct competition with larger interstate organizations. Furthermore, the investment companies bill is not purely a disclosure form of regulation, such as is contained in the registration provisions of the Securities Act; it covers a wide variety of activities and imposes affirmative regulations. Thus, even though Texas Fund and similar companies are known locally so that disclosure is less necessary than in interstate companies, there nevertheless would be a great need for the many affirmative regulations imposed by the bill, for which, of course, disclosure is no adequate substitute. (Thus, full knowledge of loads imposed by Texas Fund and similar companies would not prevent exorbitant loads from being charged.) The enactment of an exemption similar to that contained in section 3 (a) (11) would result in the creation of numerous companies like Texas Fund, which would immediately place interstate companies at a complete disadvantage and in a large measure nullify the protections afforded by this bill.

THE TEXAS FUND, INC.,
Dallas, Tex., June 12, 1940.

Hon. WILLIAM P. COLE, Jr.,
Chairman of Subcommittee,
Interstate and Foreign Commerce Committee of the House,
Washington, D. C.

DEAR MR. COLE: We wired you today, thanking you for your telegram to us of June 11, with reference to hearings on the pending investment trust bill. As stated in our telegram, we are not in a position to send representatives to appear personally before your committee.

The Texas Fund, Inc., is a company organized under the laws of Texas, selling its sponsored trust certificates only to bona fide residents of Texas. It began

active business in January 1938. It is solvent and its sales have been good considering the unusual conditions brought about by the war. Its certificates now sold, most of which are on the periodic deposit plan, are a little less than $1,000,000 in principal amount, of which about $110,000 (exclusive of service fees) is paid in. The trustee is the Mercantile National Bank at Dallas. The company is of the semifixed unit type with a portfolio consisting presently of 30 standard common stocks listed on the New York Stock Exchange.

We understand that the bill, as it came out of the Senate committee, provides that the minimum monthly deposit cannot be less than $10 and that the minimum initial deposit may not be less than $20. We respectfully submit that the bill should be amended so as to make the minimum deposit, whether initial or otherwise, not less than $5. The principal reasons for this suggestion are as follows:

1. We have found, through our 2½ years of selling experience, that there is a definite field in our section of the country for investments of this type requiring as little as $5 per month to be deposited. The field includes not only individuals with small incomes but a considerable number of people with substantial incomes who wish to diversify their investments and do not care to put more than $5 per month into our periodic plan.

2. The fact that an individual may not be able or willing to deposit more than $5 per month under our plan should not deprive him of the privilege of participating in the higher average earnings on common stocks, which would be otherwise impracticable for the small investor.

3. Our experience discloses also that individuals depositing $5 per month are not necessarily more inclined toward becoming delinquent in their deposits than investors depositing larger amounts.

4. We understand that recognition of the above facts has been conceded in the fact that Investors Syndicate, Inc., has not been subjected to a minimum monthly deposit with respect to their contracts. There would seem no valid reason for distinguishing in favor of the Investors Syndicate plan since both their plan and ours are intended as long-term investment plans and neither is represented as a checking or savings account.

5. Likewise, the above principles have evidently been given wide recognition over a period of many years by the fact that life-insurance companies sell cash value type policies for amounts involving annual premiums as low as $15 or $20; in fact, a premium of $5 per month ($60 per year) is considered a good-sized premium on individual policies even though a very small percentage of it goes for actual insurance protection. Since only a portion of the premium is used for insurance, a substantial portion is considered an investment. If the distinction is made that the small insurance premium (a portion of which is invested and a portion of which goes for insurance protection) is justified because it immediately creates an estate, this distinction would not necessarily hold true between insurance policies and our certificates under which an insurance feature is available. The face amount of the insurance (in connection with our certificates), plus the accumulating cash value of the certificate, generally provides a substantially larger total estate per dollar of cash outlay than most types of life insurance policies provide.

We feel that the requirement as to deposits in the pending bill would deprive many small investors of the privileges of the plan and would seriously handicap the legitimate operations of companies of our type.

We, therefore, respectfully request that consideration be given to an amendment decreasing the minimum deposits, as above set forth.

Very respectfully yours,

LOGAN FORD,
Vice President.

JUNE 13, 1940.

MEMORANDUM IN REPLY OF TEXAS FUND, INC., THAT THE BILL BE AMENDED TO MAKE THE MINIMUM PERIODICAL PAYMENT ON CERTIFICATES $5 PER MONTH INSTEAD OF $10 MONTHLY

The letter of the Texas Fund, Inc., dated June 12, 1940, asserts five reasons that minimum monthly payment on periodic payment plans be permitted to be $5 per month instead of $10 monthly.

1. Texas Fund states that there is a definite field in their section for investments of that type requiring as little as $5 per month to be deposited, including not only individuals with small incomes but a considerable number of people with substantial incomes.

This point simply states that the fund would like to sell this type of certificates and that these certificates can be sold to many purchasers on that basis. This assertion completely disregards the basic consideration whether companies should be permitted to sell, by usually dubious sales methods, this type of certificate. The investigation by the Securities and Exchange Commission of these certificates clearly indicate that they constitute always a potential fraud upon the investor.

The report of the Securities and Exchange Commission on companies sponsoring installment investment plans which contains an analysis of the effect of small monthly installment payments, shows that the small size of the monthly payments enables the company to obtain subscriptions from individuals who were in no financial position to maintain regular payments over a period of time as long as 10 years. Proof of this fact was established not only by the testimony and in numerous individual cases but by a statistical survey which showed a heavy rate of lapses. These lapses were accompanied by severe losses to the investor. The testimony of certificate holders in injunction proceedings instituted by the Securities and Exchange Commission and in cases in the courts disclose the utter ignorance of a great many of these people as to the nature of their investment. These people thought they were saving money and had no idea of the fees and charges that were deducted. Many of them did not appreciate the fact that they were investing in common stocks. Many of them believed they were buying ordinary life insurance policies.

During the course of the investigation by the Securities and Exchange Commission of the sales methods employed by periodic-payment plan companies it was ascertained that less than 5 percent of the hundreds of subscribers who were examined really had any idea as to the nature of their investment, and the vast majority of the plan holders who had been induced to buy their plans by gross misrepresentations in material facts were the people in the smaller-income brackets. These purchasers included truck drivers, domestics, laborers, housewives, etc., and others who had little financial experience or knowledge.

At a preliminary conference between members of the Commission's staff and leading members of the installment investment plan industry, there was unanimous agreement that unless the monthly payment was at least $10 per month these certificates would be sold to people who could not afford to keep up regular payments over so long a period of time and to people who were easily misled or imposed upon. Some members of the industry suggested $15 as a minimum monthly payment. Others suggested $20 as an initial payment and $10 monthly payments thereafter. At a subsequent conference the latter requirements were requested by the members of the industry and the Commission felt inclined to concur. One company has voluntarily fixed a minimum payment of $25 per month.

Specifically in answer to the statement that the field includes not only individuals with small incomes but a considerable number of people with substantial incomes who wish to invest in more than $5 per month, it is submitted that such number cannot in fact be considerable and that such people, if any, in the public interest must suffer the small inconvenience so that the beneficient purposes of the bill may be manifested.

2. The letter states that an individual who cannot afford more than $5 a month should not be deprived of the privilege of participating in the higher average earnings on common stock, otherwise impracticable for a small investor. The statement "higher average earnings on common stock" is itself misleading in itself. If this is the type of representation made to the small investor without careful qualification, it may well be a misrepresentation. It does not indicate the certificate holders in the underlying common stocks are really investing or speculating.

3. The letter states that the experience of the Texas fund disclosed that individuals depositing $5 a month are not more delinquent than larger investors. It is significant that there is no statement as to the lapse experience of these so-called larger investors.

The experience of the Texas Fund is a short one. Mr. Henry J. Simonson, president of Independent Fund of North America, formed one of the first installment plans about 10 years ago. He testified before this subcommittee that in his experience the rate of lapses among the $5 investors was approximately 70 percent

of all such contracts sold. The study of the Commission definitely indicates that the lower the monetary payment the higher the lapse rate.

4. The letter states that the face-amount companies have not been subjected to a minimum monthly payment. The proposed bill makes it virtually impossible to sell face-amount certificates below the $10 per month. Furthermore, the nature of the portfolio of face-amount companies as provided in the bill must consist of "legal" investment is entirely different from periodic plans which have portfolios of common stocks.

5. The letter cites an allegedly analogous situation of an insurance policy requiring a premium of even less than $5 per month of which a substantial portion is considered investment.

The insurance contract is, of course, an entirely different one from the installment investment plan. The insurance company obligates itself to pay a fixed amount at the end of a certain period. The installment investment plan only obligates itself to repay the liquidating value of underlying common stocks at the time of liquidation. Moreover, the insurance company invests in "legals" whereas the installment investment plan speculates in common stock.

Mr. COLE. Now, Mr. Hollands, do you have any additional statement to make?

Mr. HOLLANDS. No, sir.

Mr. COLE. Mr. Jaretzki?

Mr. JARETZKI. No, Mr. Chairman.

Mr. COLE. Mr. Motley.

Mr. MOTLEY. My purpose has been to sit here, in case the committee had any questions they might wish to ask of me.

I do not think of anything to add to what Mr. Schenker and Mr. Maretzki have said. Mr. Jaretzki and I have been working very closely with Mr. Schenker and Mr. Hollands, and Judge Healy, in the preparation of this bill, and we are very familiar with it, and on behalf of the open-end industry, I want to add to what Mr. Jaretzki said on behalf of the closed-end companies that we are entirely satisfied with the bill as it stands, and we believe that the members of the industry in general are entirely satisfied with it, and we hope very much that it will pass.

Mr. HEALY. May I say one word before you close?

Mr. COLE. Yes.

Mr. HEALY. I would like to express to the committee our thanks and appreciation for the attention and courtesy we have had here.

I would like to add deliberately a further word of optimism as to the possible future of the investment trusts. I think it is rather fortunate perhaps that the investment trust industry encountered its difficulties and a governmental study comparatively early in its history, before bad practices and abuses and evils had gotten so completely frozen in that they could not be rooted out or where the leaders of the industry would not be willing to do what they have done here, and that is, sit down with Government representatives and recognize those evils and try to get rid of them.

It leads me to hope, and it leads me to express the belief I have that under this regulation and under the kind of sensible and honest management. I believe those we are going to have for these trusts, that they will have a very fine future, a very promising future, one rendering useful service to the small investor. I believe they can make a definite and very useful contribution to our economy and national welfare.

Mr. COLE. Is Mr. David T. Sanders in the room? Is there any representative of Mr. Sanders here? Mr. David T. Sanders, of Chicago.

Mr. MOTLEY. Mr. Sanders of Chicago. I think that he is the Chicago representative of the Massachusetts Distributors, of which Mr. Traylor is president. Mr. Traylor appeared here yesterday in favor of the present bill. Mr. Sanders appeared as a witness in the Senate hearings. He has not been present yesterday or today.

Mr. COLE. I have a telegram to the effect that his representative would be here.

Mr. MOTLEY. I assume that is the same man.

Mr. COLE. Let me ask if the Fiduciary Counsel, Inc., has a repsentative here. I do not know who was to represent them, but I have a telegram here saying that they approve of the Wagner bill and ask that the record so state.

The committee is also in receipt of a wire from Roland A. Robbins, vice president of the F. I. F. Plan, Inc., of New York. The wire is approving the bill.

If there is no one else to be heard we will close the hearings at this point.

(Thereupon, at 12:35 p. m., the hearings were concluded.)