

data which indicated that it used the terms "income" and "profits" in the usual ordinary way.

After the statement had been effective for quite a while—about a year or more—we found that that company was using and had not disclosed a very peculiar formula by which it worked out what it was calling profits and income. It did not by any manner or means account for income and profits in the ordinary sense that a man would use it. The management could so shuffle the assets under their formula as to make a profit any time they wanted to. They would mark up assets and they would reappraise them and revalue them, and they did. They would then take that unrealized or marked-up appreciation and put it into income, and out of that would pay dividends—so-called dividends.

They would pay that because their remuneration depended upon and was a certain percentage of the dividends paid out.

From 1933 to 1938 we found that this particular concern, without disclosing what it was doing, had paid out \$851,000 in so-called dividends, when, as a matter of fact, it had been operating during the entire period at a loss, and had taken as commissions on those "dividends," 10 percent, or eighty-five thousand some hundred dollars for itself. It did not disclose—

Senator HUGHES (interposing). Was that from the dividends?

Mr. BANE. That was additional, out of the trust. It got as its management fee 10 percent of the amount it paid out in dividends.

When we discovered this, we could get a stop order against them, and we did; this Investment Trust Act to a large extent prevents such practices.

Senator WAGNER. Did the investors get part of the money back?

Mr. BANE. The investors got part of it back, a return of capital.

Senator WAGNER. Did any of the \$861,000 represent profits?

Mr. BANE. Not a bit. It had been operating at a loss entirely. The public could not get out as much as it put in. It had taken out its own fees for management and it had been operating at a deficit.

Senator HUGHES. The paying of the dividend, of course, was helping to sell their securities and pointing out the fact that they were earning money?

Mr. BANE. It was helping to sell their securities and also giving a return to the sponsors for a management fee.

Senator WAGNER. Do you happen to know how those securities were sold and to whom?

Mr. BANE. They were sold, as I described, to the average, small investor as a safe investment for this savings.

Senator WAGNER. Were they advertising that?

Mr. BANE. As I remember, when we got into examining the case, there were few persons in the trust who owned more than a \$500 interest, so it was sold chiefly to the investor who invested \$500 or less.

Senator WAGNER. I was wondering about the type of people they were and whether they were solicited.

Mr. BANE. There is one other thing that I might mention, Senator. The peculiarities of accounting in some of these investment trusts—I do not mean all—

Senator WAGNER. We all understand that.

Mr. BANE. The peculiarities are something marvelous sometimes, and the peculiarities are dependent in many instances on how the various fees are paid.

This man had a contract and he represented to those to whom he offered the securities, "If you do not profit, I do not profit. My management fee is only on a certain percentage of the income or the dividend." So he had to pay a dividend to get anything. Therefore, he went through all kinds of tricks in accounting in order to get up an income from which he could pay that dividend, and whenever you get the fee of the management in these investment trusts largely dependent or wholly dependent upon either profits, income, or dividends for payment, the methods followed are almost fantastic in order to get something that they may call profit or dividend to pay the "income" in order that they might get that fee.

We make them set the thing up on a proper accounting basis from a disclosure standpoint. We cannot, however, stop them from paying so-called dividends if they want to. We do make them state that that dividend is a return of capital.

Senator WAGNER. A return of capital?

Mr. BANE. A return of capital. We make them show that that so-called dividend is a return of capital to the investor.

Senator HUGHES. Where do they show that? On the check?

Mr. BANE. They show it in the prospectus. We make them say that this dividend constitutes largely a return of capital.

Consider the type of person to whom these securities are offered and sold. What does a return of capital mean to that person? Return of capital to them is just the same as dividends from income. They do not distinguish between them. That is true of some of these holders who are fairly well educated.

I happen to know a young lady who is a college graduate and teaches at high school, and she thought she was getting the equivalent on her trust of a return of income to the extent of 12 percent a year.

We can make them disclose those things, but we cannot prevent them, we cannot regulate them, and we cannot give to the person to whom they make these representations the ability to make them understand.

Senator WAGNER. You said a moment ago that this particular concern paid out \$800,000. Was it in dividends?

Mr. BANE. Yes.

Senator WAGNER. Over a period of time?

Mr. BANE. Yes.

Senator WAGNER. Will you tell us about the character of the investments they made during that course of time?

Mr. BANE. Yes; we had that portfolio before us. I know they had some securities, and I am informed by some of the men here who are familiar with it that all of their securities were listed on the New York Stock Exchange or New York Curb. But you will realize, Senator, that some portfolios of listed stocks comprise practically every stock on the exchanges, and the management can use poor judgment, and there are some speculative stocks on the exchanges.

Senator WAGNER. I wondered if any of them went into any actual business ventures.

Mr. BANE. Not in this particular case, but we do have some that do. We had a stop order against a concern that represented to us when it filed that it was going to invest the money that it obtained

from the public in listed securities on the New York Stock Exchange or the New York Curb. After it got the moneys, and it sold something like \$100,000 worth of securities, we got information tending to show that they were putting that money not in New York Stock Exchange or the New York Curb listed stocks, but in highly speculative securities, and in one instance were loaning it to an officer of the management and taking his unsecured note in return.

We succeeded in procuring a stop order against him and preventing further sales.

We also found one that had done the same thing—sold them on the basis of investments in the New York Stock Exchange and invested it in timberland in the South.

Senator WAGNER. I think I recall Mr. Schenker referring to one in which \$100,000 was used to operate a laundry of some kind.

Mr. BANE. The one that I refer to used to operate timber property, and there was one that I told you about that used it to operate a farm and patent-medicine business. And these investment trusts are very easy to organize.

We had one, somewhat similar to the one mentioned a few moments ago, which represented that it was going to buy securities on the New York Stock Exchange or the New York Curb. Instead we found that it was putting all the funds in another affiliated investment trust, and which second trust I do not think required that its funds be invested in listed securities.

Do you want any more?

Senator WAGNER. They are all very interesting. How many more are there?

Mr. BANE. We have had proceedings under section 8 of the Securities Act, which is the one we issue a stop-order under.

We had proceedings under this section against approximately 43 concerns of the 265 that are registered with us.

We had stop-order proceedings against the Equity Corporation. I do not want to go into it, because I am sure Mr. Schenker is going to cover it in detail and cover the background and history. The Equity Corporation filed with us, and we had a stop-order proceeding against it and its affiliate, Consolidated Funds. Those were two large investment companies, and we commenced stop-order proceedings and as a result thereof they corrected their registration statement to make accurate disclosure.

Senator HUGHES. They are not engaged in business now?

Mr. BANE. They are engaged in business; they are not selling securities.

Mr. SCHENKER. The Equity Corporation is the one which now owns the United Founders Corporation that we were telling you about.

Mr. BANE. I did not want to go into that, because I thought Mr. Schenker was going to handle that. We had a somewhat different concern that we got a stop order against. It was one of those installment-plan companies. You deposit \$10 a month with it and it would buy shares in another trust as its underlying portfolio. You deposited \$10 a month for 10 years, 120 payments, and instead of

what its actual charter showed you—that is, that you got at the end of those 10 years whatever your proportionate share of the underlying portfolio was—they were telling the purchaser that he had a \$2,000-face-amount contract, that is,

If you deposit this \$1,200 with us, \$10 for 120 months, we will give you at the end of that time \$2,000,

whereas the actual obligation was only to give you, in their contract, your proportionate share of what that underlying portfolio was, and the only way to get \$2,000 was for another trust to come in and enhance to the \$2,000, the amount you invested, less deductions.

We had another one file with us—to show how fantastic some of these are—where he actually offered to the public—said so in the literature, upon the deposit by the purchaser of \$25 a month for 10 years, at the end of another 10-year period they would pay him \$42,000.

We took the stocks in which he said he intended to invest—the portfolio—and we examined those and we found that the maximum annual return that could be expected from those was 3½ percent, and we could not figure out how \$25 a month deposited for 10 years could possibly be built up to \$42,000 in that time.

Senator WAGNER. I suppose some of the sponsors said that the Government was interfering with their business?

Mr. BANE. I have heard the complaint once or twice, Senator.

Senator WAGNER. Have you any other questions?

Senator HUGHES. No, I think not. Senator, you have intimated that I have unusual knowledge of ways that are dark.

Senator WAGNER. No, but in my discussions with you I know that you know some of these methods that have been used.

Now, there are some witnesses who are yet to appear either in opposition or to explain or make suggestions in regard to this bill, and we would like to have some idea of the amount of additional time the Commission will take.

Mr. HEALY. I would like to have an opportunity to discuss that with my brother commissioners in the morning or afternoon. I can say this: The decision is not a very easy one from our point of view. We are very anxious not to give the Congress the impression that we are just fooling around with a few isolated instances of fellows who have looted and stolen trusts.

We have a great deal of these instances that we can describe, and what perhaps may be more important, we can describe the economic problems that grow out of situations where actual dishonesty is not involved.

Senator WAGNER. I do not think we have had any testimony which you could characterize as insignificant. My impression is that it has been just the opposite.

Mr. HEALY. A good deal depends on how much the committee wants to hear.

Senator WAGNER. Well, we want a complete picture of this whole problem. You have been living with this subject for some years and we are getting it now for the first time. We want to absorb it, and it takes a little time. You must be a little patient with us. When you take one company on top of another, it is very difficult to follow you.

However, I do want to have some idea as to how many are going to appear after the Securities and Exchange Commission witnesses and when they may be expected to be heard. We want to have a complete picture and have everybody who has an interest given a chance to be heard. Yet we cannot be here interminably because I am hoping that the committee will act upon the legislation very soon after the hearing is closed.

Mr. HEALY. Do you want to hear any of the witnesses from the Commission discuss the specific provisions of the bill before you hear the industry?

Senator WAGNER. I think we ought to have that, too.

Mr. HEALY. I think it might be fairer to the industry if they had a chance to meet the suggestions that we have.

Senator HUGHES. I presume that there are persons engaged in the industry, as you call it, present or will be present, and they could hear your explanations, and then, when they see fit to testify, they can do so.

Mr. HEALY. Very well. May I get in touch with your office in the morning, Senator, to try to arrange a program?

Senator WAGNER. (chairman of the subcommittee). Yes. At any rate, we will resume the hearing on Monday at 10:30. Whom do you expect to be here?

Mr. SCHENKER. We will give you the list at the time we communicate with your office.

(Thereupon at 1:05 p. m. an adjournment was taken until Monday, April 8, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

MONDAY, APRIL 8, 1940

UNITED STATES SENATE,
SUBCOMMITTEE ON SECURITIES AND EXCHANGE
OF THE BANKING AND CURRENCY COMMITTEE,
Washington, D. C.

The subcommittee met, pursuant to adjournment on Friday, April 5, 1940, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), and Downey.

Senator WAGNER. The subcommittee will proceed. There will be other members of the subcommittee present a little later on, I am sure. We must have conversation in the room stopped. It is not fair to witnesses or to members of the subcommittee to have conversations going on in the room.

Judge Healy, would you like to make a statement?

Mr. HEALY. Yes, Mr. Chairman.

Senator WAGNER. You may proceed.

STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.—Resumed

Mr. HEALY. Mr. Chairman, at the close of the testimony last Friday I requested permission to consult with the other Commissioners before attempting to reply to your inquiry as to what further testimony the Commission thought it necessary to submit. In view of the chairman's suggestions, we propose to offer this morning a very brief discussion of those companies which sell investment trust securities to small investors on the installment or periodic-payment basis.

The Commission feels that after the completion of that testimony there will have been presented to the subcommittee a fairly comprehensive picture of the investment-trust industry and its characteristics. Although the picture has necessarily been limited to a very brief outline, it should be possible to fill in many details in the course of the discussion of the specific provisions of the bill.

Accordingly we would like to begin, later this morning, an exposition of the bill, section by section. I wish to make it clear that moving to the discussion of the bill at this time does not mean that we have run out of material. Our principal embarrassment thus far has been due to the difficulty of deciding what material to select from the large amount available. For the complete picture, of course, we must refer the subcommittee to the full report of the investment-trust study.

If it is agreeable to the Subcommittee, Mr. Boland of our staff will take up the investment-trust companies that sell their securities to small investors on the installment or periodic-payment basis.

Senator WAGNER. Very well. You may proceed, Mr. Boland. Keep your voice up, please.

STATEMENT OF JOHN BOLAND, ATTORNEY WITH THE GENERAL COUNSEL'S OFFICE, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. BOLAND. Mr. Chairman, the periodic-payment plan certificates are really tripartite contracts between the sponsor or distributing company, the trustee, which is generally a large financial institution, and the subscriber, under which the subscriber is called upon to make certain monthly installment payments over a period generally running for 10 years.

These monthly payments have ranged as low as \$5 a month and as high as \$200 a month. However, our survey shows that the most widely distributed plan was one which called for payments of \$10 per month.

As a rule the subscriber makes his payments directly to the trustee, which deducts its own fee and the service charges of the sponsor company, and then applies the balance of the payments to the purchase of shares in a regular fixed type or management-type of investment trust.

In the purchase of these underlying shares there is an additional sales load, ranging from 5 percent to 9½ percent, which must be paid by the subscriber. In more simple terms, the periodic-payment plan is one trust superimposed upon another trust, with two trustees and two sponsoring companies. You can see, therefore, that the investor must pay two sets of trustees' fees and two sets of service charges or sales loads, and—

Senator WAGNER (interposing). Will you explain that in a little more detail, as to what you mean? Please explain how a trust is superimposed upon another trust. Whose property does the particular certificate that has been purchased, or share, represent? Is it the first trust, the second trust, or both, or how is that done?

Mr. BOLAND. If you please, Mr. Chairman, the top trust is really the periodic-payment-plan certificate which is created by the sponsor company. The periodic-payment-plan certificate subscriber pays into the trustee of the top trust these monthly payments. After the top trust trustee makes these deductions for its fee and the fee of the top trust sponsor company, the balance is used to purchase shares in an underlying trust. The underlying trust is a regular investment trust of the fixed type or the management type. So that all that the contract holder in the top trust gets is an equity in the underlying trust.

Senator WAGNER. What I would liked to know is this: Is there any public interest reason for two trusts of that character; is there some special protection to the investor in the creation of two trusts, one a fixed-type trust and the other a top trust?

Mr. BOLAND. These periodic payment plans originated early in 1930, when the investing public was undergoing its most tragic experience in overspeculation, and were designed to contact the very