

REAL ESTATE BOND ISSUES OF THE FUTURE

ADDRESS

of

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before the

NATIONAL MORTGAGE BOARD

of the

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No appraisal of the American economic scene can be accurate which fails to stress the importance of real estate financing. A wise and proper policy with respect to such financing is indispensable to genuine recovery. A return to the policy of the post-war years may corrode the entire financial structure beyond the possibility of repair.

Before considering the real estate bond of the future, I would like to discuss with you some mistakes of the past. While such a backlook embraces territory all too familiar, it has its value. The prudent man lights his torch at the candle of experience. If we are on the road to recovery -- and many believe that we are -- it is all the more appropriate that we keep green the memory of past errors, no matter how painful that memory may be.

A report submitted to the House of Representatives by the Select Committee to Investigate Real Estate Bondholders' Reorganizations states that approximately \$10,000,000,000 real estate bonds are outstanding of which \$8,000,000,000 are in default, affecting directly or indirectly about 20 million of our citizens.

In New York an appalling disaster to investors culminated in the Insurance Department taking over 18 of the leading companies engaged in the business of guaranteeing and selling whole mortgages and mortgage certificates. On December 31, 1933 these companies had outstanding guaranteed mortgages and certificates in the sum of \$1,783,000,000 of which over a billion dollars were in default. Several hundred thousand investors were affected by the collapse of these companies.

The impact of such a calamity is particularly devastating because of the character of its victims. The individual who buys a real estate security is not ordinarily a speculator or a gambler. He is more likely to be a person of modest means who is induced to invest his savings not so much by any consideration of the merits of the security as by his faith in the concern with which he deals. This was undeniably true in the case of those who purchased guaranteed mortgages and certificates. Perhaps in no other field of investment did the purchaser so completely assign his judgment to the keeping of others. And seldom has he been more completely betrayed.

The multitude of abuses which combined to make this one of the most gigantic betrayals in the history of American investment are so clearly and forcefully exposed in the report of the Moreland Commissioner appointed by the Governor of New York that I am impelled to restate a few of his findings.

(1) Many investors learned for the first time after the collapse that their certificates covered vacant land despite advertisements by the companies that loans were confined to "income producing" or "improved" property.

(2) Others bought certificates covering specialties which, as every mortgage broker knows, involve greater hazard than loans on residential property since upon default they are likely to present all the disadvantages of a loan on vacant land with a "white elephant" thrown in for good measure.

(3) Certificates were sold on the basis of appraisals which were several years old or which failed to give effect to sharply declining market prices or to the fact that foreclosure proceedings had been brought against the property. Appraisal figures on occasion were arrived at by the simple expedient of multiplying the amount of the loan required by 1 1/2 which satisfied the statute and made it unnecessary to inspect the property. Fortunately that kind of appraisal has not come into general use.

(4) After large financial institutions, fiduciaries and other experienced purchasers had selected the cream of the whole mortgages, the leavings were certificated for the benefit of the least discriminating class of all — the buyers of certificates, who relied almost entirely on the guarantee of the issuing company. By this system the risk was distributed among investors in inverse ratio to their ability to sustain loss.

(5) Many investors who believed that they were receiving the bond of a responsible borrower, eventually discovered that the borrower was a subsidiary of the guarantee company, whose bond added nothing to the guarantee, or a corporation formed for the express purpose of avoiding any liability in excess of the property mortgaged.

(6) The companies frequently designated themselves to act as trustees or depositaries for their own certificated issues, thereby exposing themselves to the temptation not only to neglect the deposit of appraisals, insurance policies, etc., but also to syphon off the good mortgages and substitute inferior ones.

(7) Perhaps the most flagrant abuse of all was the sale of certificates and mortgages which were in default for non-payment of interest, taxes or principal. Over 80% of the certificates sold by one company in 1932 and 1933 were in default when they were sold. Company officials professed to be completely ignorant of such defaults. An amazing lack of coordination was revealed between those departments of the companies which were charged with supervising the collection of interest and the payment of taxes and the salesmen who blithely continued to sell certificates, come weal come woe!

(8) Moreover, when a default occurred, the companies concealed the fact and continued the payment of interest until maturity when the unsuspecting customer might the more readily be induced to reinvest his principal.

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It is not to be supposed that all the evils in mortgage banking were in the field of guaranteed mortgages and certificates. There are few fields of real estate financing in which laxity and haste were unknown; in which "convenience-appraisers" did not thrive; and in which fundamental concepts of sound valuation were not ignored.

From our present point of vantage we can see with unclouded vision the easy standards which prevailed in a world from which it was commonly believed poverty and hunger had been banished. We know now that those easy standards will not do in today's world or tomorrow's. They must be supplanted by new standards which recognize the simple fact that the investor's interests are of paramount importance not only to himself but to the society which needs him so badly. This point cannot be too strongly emphasized now, at this moment, when the destinies of the building industry and the mortgage business are matters of such grave and universal concern.

On every hand measures are being taken to facilitate real estate financing. Legislation adopted at the last session of Congress liberalized mortgage lending by member banks of the Federal Reserve system; increased the appropriation of the Home Owner's Loan Corporation by \$1,750,000,000; reduced the cost of mortgage insurance; authorized the expenditure of \$450,000,000 for low and moderate cost housing projects; and in other respects pushed forward the program of stimulating housing construction on a broad front.

I have no intention of venturing to predict the future of real estate in such expert company as this. One need not be an expert, however, to recognize some plain facts about the building industry. With an aggregate volume of approximately \$11,000,000,000 during the peak year, 1923, it is among the three largest industries in the United States and the second most prolific source of employment for skilled, unskilled and professional labor. A host of other industries are affected by its ebb and flow.

It has been estimated that due to the unprecedented building paralysis of the last five years our housing deficit now exceeds 1,450,000 homes. Construction has barely kept abreast of destruction and obsolescence. Vacancy surveys indicate that in many sections of the country vacancies have virtually disappeared both in small residences and apartments. Blighted, slum and over-crowded areas, inimical alike to our social and economic progress, cry out for correction.

It has also been estimated that during the next ten years, in order to satisfy the demand created by increase in the number of families, cumulative shortage, units to be demolished, ordinary disappearance through fire and act of God, and a necessary reserve of homes, several million dwellings will be required. The picture is fraught with promise for the future--promise that great masses of men will be put back to work and promise that the American standard of living will be immeasurably enriched.

But before those promises can be translated into reality three essential factors must be introduced into the picture:

First, the cost of housing must be brought down in relation to other costs. The present cost of purchasing a plot of ground and constructing a dwelling thereon is far more than four-fifths of the families of the nation can afford to pay. The average citizen should not be permitted or encouraged to buy or borrow on an unhealthy basis. We have seen too often the disastrous results of over-straining the family budget.

In the second place, a new technique of real estate financing must be evolved which will take the curse off the mortgage. As the Federal Housing Administrator put it the other day, "The word mortgage has become a synonym for nightmare." There is a story about the four Marx Brothers in the wild days of their youth when their mother managed their vaudeville engagements. The boys were incorrigible practical jokers and occasionally their unrehearsed and unscheduled antics in front of the audience seriously impeded the progress of the performance. On such occasions Mrs. Marx standing in the wings would softly whisper "Greenbaum". The effect upon the boys was instantaneous; they would sober up and promptly get back to their routine. The magic formula was exceedingly simple; Mr. Greenbaum held the mortgage on the Marx home.

Owners of real property in the past usually exhibited toward their holdings an attitude implying that they would gladly pay somebody to take them away. You have all known property owners of that sort. Underlying that attitude was the ever present fear of the mortgagee. The home owner was clawed incessantly by worry. The recollection of those fears remains to this day a major deterrent to the purchase of homes.

The third factor still lacking for the development of gigantic building program is the confidence of the investing public in real estate securities. That confidence will not be fully restored until it is deserved. In its absence the program cannot go forward except at a snail's pace. The task of winning the investor back to belief in real estate as a medium of investment is, in no small measure, your own.

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I turn now, with some hesitation, to a consideration of the real estate bond of the future. Your prognostication as to its essential characteristics would probably be more accurate than mine. Nevertheless, since you have invited me to express an opinion, I venture to say that, if and when there is a general revival of interest in mortgage financing, the real estate bond of the future and more particularly the bond secured by a mortgage on residential property, will present a contrast to the real estate bond of the past in several respects.

(1) It will be secured by a first lien on the property and will be written for a large enough percentage of the property's fair value to take care of the borrower's needs without imperiling the lender. Hence, the second mortgage on residential property will probably become obsolete.

(2) It will bear a progressively lower rate of interest as its safety and liquidity factors rise. In time a security bearing a higher rate than 4 1/2% may be regarded as extortionate.

(3) It will run for a longer term than heretofore, particularly in the case of home mortgage loans, which will be amortized by monthly payments commensurate with the borrower's income. Renewal fees and bonuses should dwindle to the vanishing point. Moreover, the recurrent dread of foreclosure and eviction which the home owner suffered every two or three years as his mortgage became due will be replaced by a feeling of permanence and security.

(4) It will possess a greater degree of stability and marketability either by virtue of the creation of a federal mortgage bank, as your association has urged, or an expansion of the activities of existing governmental agencies.

(5) It will tend to become a less hazardous form of investment, because it will be more intelligently adapted to the borrower's ability to pay; because the investor will have access to more accurate and comprehensive information; and because it will be based on sounder valuations. The selection of expert appraisers will be a matter of deeper concern to investors and issuers alike. In a field where several factors can only be approximately estimated the experience, judgment and integrity of the appraiser are matters of prime importance.

These are some of the tendencies of modern real estate financing. What part does the Securities and Exchange Commission play in this picture?

There is nothing in the Securities Act of 1933 or in the Securities Exchange Act of 1934 concerning which any legitimate realtor or mortgage broker need feel alarm. The Acts are designed to stamp out the abuses and excesses which have flourished in the securities markets, including the market for real estate securities, and which have contributed so largely to the disruption of the nation's credit system and the dislocation of its industry and trade. But the Commission has consistently taken the position that the administration of these laws should in no way hamper legitimate business enterprises.

The Securities Act of 1933 requires that before a security is offered for public sale full and honest disclosure be made of all the facts necessary to enable the investor to exercise an intelligent judgment.

The Commission has labored for many months with the problem of formulating rules which will accomplish the desired objective without imposing unnecessary burdens upon issuers. Patient study and painstaking effort have been devoted to the complex task of simplifying the forms for registration and adapting them to the type of issuer seeking registration. While special forms have not yet been promulgated dealing with real estate bond issues the work of preparing such forms is going forward as rapidly as possible. The Commission has always welcomed the cooperation of persons qualified by experience and training to offer constructive suggestions and you may rest assured that suggestions from you concerning the regulations and forms for the registration of real estate bond issues will be warmly received.

The Act empowers the Commission to exempt from the necessity for registration any class of securities where the aggregate amount at which the issue is offered to the public does not exceed \$100,000. Acting under this power, the Commission has exempted from registration notes or bonds directly secured by first mortgage or first deed of trust on real estate or on a leasehold subject, however, to several conditions. The conditions are: That the exempted securities shall be sold for cash; that no other securities of the same class shall have been sold within the preceding year, except for cash; that the aggregate offering price of the present issue and of any other offerings of the same issuer exempted during the preceding year shall not exceed \$100,000; that if the securities are distributed through an underwriter, the net proceeds to the issuer shall be at least 90% of the aggregate offering price to the

public; and that any prospectus authorized by the issuer shall plainly state that the securities have not been registered. In addition, where the notes or bonds are in denominations of less than \$500, the exemption is not available unless the securities are in denominations of at least \$50, and unless a prospectus is filed with the Commission and delivered to the purchaser before the sale. Other exemptions from the necessity for registration under the Securities Act are provisionally granted in the case of offerings which do not exceed \$30,000 and in the case of securities exchanged for bona fide outstanding securities or claims where the aggregate value of the outstanding securities or claims does not exceed \$100,000.

Only a few days ago the Commission exempted certain securities directly or indirectly insured by the Federal Housing Administrator. The exemption applies to single mortgages not exceeding \$16,000 which are thus insured, as well as to trust instruments covering such single mortgages. It is available to an issuer even though that issuer offers mortgages aggregating more than \$100,000 during a single year.

Mortgage brokers have exhibited particular interest in the provision of the statute which exempts transactions by an issuer not involving any public offering. In this connection the Commission's General Counsel has expressed the opinion that many factors must be considered in determining the availability of this exemption including the number of offerees as distinguished from actual purchasers, and their relationship to each other and to the issuer; the size of the offering; the number of units offered; and the manner of offering. The ultimate question as to whether a public offering is involved is one of fact in which all surrounding circumstances are of moment.

These exemptions, of course, make registration unnecessary in many mortgage loans transactions. Does this mean that the purchaser of exempted mortgage bonds receives no protection under the Act? It most decidedly does not. Whether the security is exempted or not, it is unlawful for any person who sells it through the mails or in interstate commerce, to perpetrate a fraud upon the purchaser, and any person who does so incurs both the civil and criminal penalties of the Act.

Under the Securities Exchange Act of 1934, the Commission has power to regulate transactions of brokers and dealers in the over-the-counter markets. The Commission has taken the initial step in its program to insure to investors in the over-the-counter markets protection comparable to that provided in the case of organized exchanges. A broker or dealer must be registered with the Commission before January 1, 1936, if he uses the mails or the instrumentalities of interstate commerce for the purpose of making an over-the-counter market for the purchase and sale of a non-exempted security, or uses any facility of such an over-the-counter market.

The only brokers and dealers exempted from registration are those who deal exclusively in exempted securities, commercial paper, banker's acceptances or commercial bills or any securities which have not been registered or listed on an exchange and the market in which is predominantly intrastate. We have received many inquiries from mortgage brokers concerning the applicability of this exemption to them.

The Commission's General Counsel has expressed the opinion that, as a general rule, dealers who deal exclusively in whole mortgages are not required to register. However, this opinion points out that circumstances may exist in the case of guaranteed or insured mortgages or in the case of a large number of separate mortgages, such as mortgages on virtually identical residential properties in a new real estate development, where bid-and-asked quotations would exist for such mortgages and an over-the-counter market would thereby be established. This is of course clearly possible in the case of participation certificates or other instruments of partial interest in mortgages. Wherever an over-the-counter market for whole mortgages or participation certificates is thus established, dealers in such mortgages or certificates are subject to the same duty to register as are dealers in other securities for which an over-the-counter market exists. It should be pointed out that the fact that a dealer's transactions are predominantly intrastate does not of itself excuse him from registration, but is a circumstance which will be considered in determining whether or not the security can be classified as an unregistered security the market in which is predominantly intrastate.

Registration may be denied by the Commission if the applicant has been convicted within ten years preceding the filing of his registration statement, of any crime involving the purchase or sale of any security or arising out of the conduct of the business of a broker or dealer, or if he is under injunction issued by any court within ten years preceding the filing of his registration statement, restraining him from continuing any conduct or practice in connection with the purchase or sale of any security. Registration may also be denied if an applicant wilfully misrepresents or conceals any material fact in his registration statement or in any document submitted in connection with his registration or in any proceeding before the Commission. Registration may be revoked for any cause which would justify the denial of registration or for the wilful violation of any provision of the Securities Act or the Securities Exchange Act or any rule of the Commission or if the registrant has been guilty of fraud in the conduct of the business of a broker or dealer.

We are now examining the thousands of applications for registration which have been submitted to us by brokers and dealers throughout the country for the purpose of sifting out those whose business records indicate that it would not be in the public interest to permit them to register. Any broker or dealer who has an honorable record in the conduct of his business will procure an effective registration with a minimum of difficulty and no expense. Those who have been found guilty of fraud in the past will be given an opportunity to show cause before the Commission why registration should not be denied to them, and if the Commission deems it in the public interest to do so, it will debar them from carrying on the securities business.

I feel confident that the program upon which the Commission has embarked in its administration of the Securities Act and the Securities Exchange Act merits the approval and cooperation of every forward looking broker and dealer. As I understand the principles of your association, they are designed to aid that program by providing national and local clearing houses for information relating to real estate securities; by attempting to improve and standardize methods of appraising real property; by improving the market for real estate securities through the dissemination of reliable information concerning such securities and through the creation of improved facilities for dealing in such securities by the members of your association and by the general public; and by erecting and maintaining high standards of financial and moral responsibility and of fair dealing among the members of the association. With these aims our Commission is in full accord.

There are of course some people in this country who do not approve of the aims of your organization or of the Securities and Exchange Commission. I refer to the securities racketeers, the high powered salesmen selling low-powered securities, the "sell and switch" peddlers, the "boiler room" operators, the "convenience-appraisers", the purveyors of securities in ephemeral gold mines, evanescent oil wells, and chimerical real estate developments, and all the other swindlers who bludgeon the unwary out of their savings with the weapons of misrepresentation and concealment. The disapproval of this class of persons is a distinction which neither your organization nor the Securities and Exchange Commission can ever afford to be without. I have a feeling that their numbers are decreasing and that in the not too distant future they will be as rare as the gold brick peddler is today. But they will not vanish of their own volition; they must be exterminated. The price of their extermination is a never-ending vigilance, and this price the Commission and every member of its staff is ready and anxious to pay. In this work we need the cooperation of every broker and dealer who recognizes that the success, and perhaps the very existence of his business, depends upon the restoration of public confidence in securities and that such confidence will be restored only when the abuses and those responsible for them have been eliminated from the scene.