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INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940

JUNE 6 (legislative day, MAY 28), 1940.—Ordered to be printed

Mr. WAGNER, from the Committee on Banking and Currency, submitted the following

REPORT

[To accompany S. 4108]

The Committee on Banking and Currency, to which was referred a bill (S. 4108) to provide for the registration and regulation of investment companies and investment advisers and for other purposes, having considered the same, reports favorably thereon, and recommends that the bill do pass.

This bill is a substitute for S. 3580, introduced March 14, 1940. The original bill was the outgrowth of an extensive study and investigation of investment trusts and investment companies conducted by the Securities and Exchange Commission pursuant to the direction of the Congress. A subcommittee held hearings on the original bill extending over a period of approximately four weeks. At these hearings, while the immediate need for national legislation regulating investment companies was conceded by virtually every witness who testified, representatives of the companies affected expressed considerable opposition to some features of the bill. Many of these joined in submitting to the subcommittee, at the close of the hearings, concrete proposals to regulate investment trusts and investment companies.

Almost immediately after the conclusion of the hearings, representatives of the investment companies and of the Securities and Exchange Commission advised the chairman of the subcommittee that they believed it might be possible for them to reach a common ground and to submit a joint recommendation as to the scope and provisions of the bill. The chairman encouraged them in this endeavor, and as a result of their cooperative efforts, the substitute bill (S. 4108) was drafted.

The substitute bill represents the result of intensive effort for a period of some five weeks by representatives of the industry and of the Commission. Not merely the principles of this bill, but also its

provisions as drafted, are strongly endorsed both by the Securities and Exchange Commission and by almost every company which appeared in opposition to the bill as originally drafted. In addition, the substitute bill is endorsed by a number of companies which did not appear either in opposition to or in support of the original bill. Thus the substitute bill, as introduced and reported, has the distinction of having the virtually unanimous support of the persons for whose regulation it provides, as well as of the regulatory agency by which it is to be administered. Representatives of the industry urged upon the committee that the present international situation should not only not be a deterrent to the enactment of this legislation but should rather serve as a vital reason for its immediate passage. As was stated by the representative of a substantial portion of the investment company industry at the close of the hearing:

> * * * we feel that this bill is not only a workable bill, but is a bill which is a good thing for the industry. We would like very much to see it passed, and we hope very much that it can be passed at this session. The industry would like to feel that it has regulation behind it; that is, that we may know what the regulation is to be and that we will no longer live in uncertainty as to what the future holds for us. This is the type of regulation under which the industry feels it can work and which it feels will be very beneficial to the industry. We are hopeful that if this legislation passes it will constitute a stimulus to the investment company industry's contributing to venture capital.
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> * * * the critical period that we are going through now, rather than being a reason for postponing legislation, is, in our opinion, an added reason for passing this legislation. We feel that it would be helpful not only to the industry to have this legislation passed now, * * * but also * * * we feel that it is a very healthy sign that Government and industry can come together and do a constructive job of this kind.

Title I. Investment Trusts and Investment Companies

GENERAL STATEMENT

Natures and types of investment trusts and investment companies.—Investment trusts and investment companies are essentially institutions which provide a medium for public investment in common stocks and other securities. They may be divided into four broad classifications: (1) Management investment companies; (2) unit investment trusts, including the so-called "fixed trusts"; (3) periodic or installment payment plans; and (4) companies issuing face-amount certificates.

The distinctive feature of the management investment companies is that no restrictions, or only limited restrictions, are imposed with respect to the nature, type and amounts of investment which their managements may make. These companies fall into two broad classes—the open-end and the closed-end type. The peculiarity of open-end companies is that they issue so-called redeemable securities—that is, a security which provides that the holder may tender it to the company at any time and receive a sum of money approximating the current market value of his proportionate interest in the company's assets. Because of the exercise of this redemption feature, the assets of most open-end companies would constantly be shrinking if they did not continuously sell new securities to investors. It is because of this constant redemption and sales activity that these companies are called open-end companies. Closed-end companies are management investment companies which do not have

this redemption feature. They do not distribute their securities continuously but only from time to time as they need new capital. Up to 1929 nearly all investment companies were of the closed-end type. However, the open-end companies, though a relatively recent development, have expanded rapidly.

In the fixed or unit investment trusts, management discretion is completely or almost completely eliminated. The investor is sold an undivided interest in a specified package or unit of securities, which are deposited with a trustee. The underlying securities cannot be changed, or can be eliminated only upon the happening of certain specified contingencies, such as the passing of a dividend on any security in the package for a prescribed period of time, or the reduction in the investment rating of the security by a prescribed statistical service.

The so-called installment investment or periodic payment plan is in essence a device to sell investment trust or investment company shares to the public on the installment plan. These plans have been designed to tap the savings of individuals in the lowest economic and income strata of the population, for investment in common stocks. Some plans have provided for installments as low as $5 a month, but the usual payment is $10 a month and the period of payment is generally 10 years.

The so-called face-amount certificates are in essence contracts between the corporation which issues them and the purchaser, whereby in consideration of the payment of certain specified installments the corporation agrees to pay to the purchaser at maturity a definite sum, the "face amount" of the certificate; or to pay prior to maturity a specified surrender value of the certificate.

Public participation in investment trusts and companies.—Investment companies have emerged as important financial institutions only within the last 20 years. The growth of the industry has been phenomenal, particularly since 1926. During the 1920's the type of investment company which was almost exclusively organized was the closed-end management investment company. So rapid was their organization during this period, that by 1929 they were being created at the rate of almost one a day.

After the market crash of 1929, the substantial losses suffered by closed-end management investment companies acted as an impediment to the further distribution of their securities, and the rise of other types of companies was accelerated. The open-end management companies, which offered the investor the opportunity to redeem his stock or security at approximately its actual value if dissatisfied with the management of the company, and the unit investment trusts, which dispensed with management entirely, rapidly increased the sales of their securities after 1930. Although face-amount certificate companies have been in existence since 1894, the greater portion of their certificates have been sold since 1929. Finally, since 1930, periodic payment plans have attracted the savings of a large number of individuals in the lower income strata of the country's population.

The American public has invested altogether almost $7,000,000,000 in investment companies of all types. This sum may be compared with the $14,000,000,000 roughly estimated as the investment in the electric light industry. The present assets of all investment companies have a value of approximately $4,000,000,000. Investors have suffered tremendous losses on their investment in such companies.

At present, the securities of such companies are owned by approximately 2,000,000 investors throughout this country. The number of security holders of investment trusts and investment companies probably exceeds that of all other industries except utility holding company systems. It is estimated that 1 out of every 10 holders of securities of all types in this country is a holder of investment trust and investment company shares or certificates. Widely promoted as institutions for the small investor, the securities of investment companies evidently appealed mostly to that type of individual. The reports of the Securities and Exchange Commission indicate that approximately one-fourth of the common-stock holders in the large management investment companies hold 10 shares or less and well over half of all such common-stock holders hold 50 shares or less. Similarly, approximately half of the preferred stockholders in such companies hold 10 shares or less, and about 95 percent hold 100 shares or less. Stated in terms of the market values of holdings of common-stock holders, approximately one-half of common-stock holders in management investment companies hold common shares with a market value of $500 or less. The certificates and shares of unit investment trusts, periodic payment plans and face-amount certificate companies are also held predominantly by small investors.

Relationship of investment companies to the national economy.—Investment trusts and investment companies are vitally associated with the national economy. They conduct their business by the use of the mails and the channels of interstate and foreign commerce. In numerous cases they conduct a substantial portion of their business in States other than those in which they are incorporated or otherwise created. Their security holders are situated in every State and in several foreign countries. A large proportion of all corporate securities sold in this country are those of investment trusts and investment companies. For example, from 1927 to 1936 inclusive, the reports of the Securities and Exchange Commission indicate that these organizations sold approximately $6,500,000,000 of their securities to the public. These sales represented approximately 22 percent of all nonrefunding sales of corporate securities during the period. Furthermore, approximately one-half of all common stock issues registered with the Securities and Exchange Commission under the Securities Act of 1933 are those of investment companies. From the effective date of the Securities Act up to the end of 1939 approximately $2,200,000,000 of common stocks of investment trusts and companies, as compared with a total of $4,000,000,000 of common stock offerings of all types of companies, have been registered with the Commission. Investment companies are also substantial purchasers of securities listed on national securities exchanges, and their trading may have an important effect on the price movements of securities.

The Securities and Exchange Commission's studies indicate that management investment companies individually held directly or indirectly 1 percent or more of the voting stocks of 200 noninvestment companies having total assets and resources of perhaps $30,000,000,000. The enterprises subject to the control and influence of investment companies include banks, insurance and mortgage financing companies, aviation and steamship companies, oil producing and refining companies, chemical companies, motion-picture producing and exhibiting companies, steel and rubber companies, food and food products

companies, manufacturing companies of all types, department stores and other merchandising companies engaged in sales of their wares by mail order and the channels of interstate commerce.

Finally, a most significant function of investment companies in relation to the immediate needs of the national economy is their potential usefulness in the supply of new capital to industry, particularly to small and promotional ventures. Although in the past investment companies have furnished but comparatively little capital to industry, it is the hope of the committee, as well as of the investment company industry and of the Securities and Exchange Commission, that regulation of investment companies, as provided for in this bill, may stimulate venture capital and the financing of industry.

Study of investment companies by the Securities and Exchange Commission.—The study of investment trusts and investment companies by the Securities and Exchange Commission, to which reference has previously been made, furnishes much of the background and data for this bill. The study was conducted pursuant to the authorization and direction of the Congress contained in section 30 of the Public Utility Holding Company Act of 1935.

Most of the basic data of the study was obtained from answers to questionnaires, prepared by the Commission after consultations with committees of the industry. By the end of 1937, the Commission had received replies from about 700 trusts and companies of all types and from about 400 investment advisers. In addition, field studies were made of many companies. After the examinations in the field and study of the questionnaires, the Commission prepared a detailed preliminary report on each company. Each report was submitted to the company concerned for criticism and comment.

Public examinations were held on 250 companies—practically every company which had $10,000,000 or more of assets. In these public hearings the companies examined were entitled to be represented by counsel, to cross-examine witnesses produced by the Commission, and to present evidence through witnesses of their own choosing. The record of these public examinations consists of 33,000 pages of testimony and 4,800 exhibits.

Based on the data thus obtained, the Commission's reports were prepared and from time to time, as they were completed, were transmitted to the Congress. The scope and subject matter of these reports are as follows:

Part 1 of the Commission's over-all report, entitled "The Nature, Classification, and Origins of Investment Trusts and Investment Companies" (H. Doc. No. 707, 75th Cong.), deals with the scope, magnitude, and conduct of the Commission's study; the nature and classification of investment companies and the origins of the investment company movement in this country.

Part 2 of the report, entitled "Statistical Survey of Investment Trusts and Investment Companies" (H. Doc. No. 70, 76th Cong.), is a detailed statistical study of the growth of the total assets of investment companies; sales and repurchases of the securities of such companies; trading in their securities; the ownership and control of such companies; the performance of large management investment companies; the investor's experience in such companies and the portfolio investments made by such companies.

Part 3 of the Commission's report, entitled "Abuses and Deficiencies in the Organization and Operation of Investment Trusts and

Investment Companies" (H. Doc. No. 279, 76th Cong.), deals with the background of the industry in relation to abuses and contains detailed histories of various investment trusts and investment companies. In addition this part of the report deals with problems in connection with: (1) The sales and repurchases of the securities of investment companies; (2) shifts in control, mergers and consolidations of investment companies; (3) capital structures of investment companies; (4) accounting practices and reports to stockholders of investment companies; and (5) the management of the assets of such companies.

In addition to its over-all report, the Commission has submitted to the Congress six supplemental reports dealing, respectively, with Fixed and Semifixed Trusts (H. Doc. No. 567, 76th Cong.), Companies Sponsoring Installment Investment Plans (H. Doc. No. 482, 76th Cong.), Commingled or Common Trust Funds Administered by Banks and Trust Companies (H. Doc. No. 380, 76th Cong.), Investment Counsel, Investment Management, Investment Supervisory, Investment Advisory Services (H. Doc. No. 477, 76th Cong.), Investment Trusts in Great Britain (H. Doc. No. 380, 76th Cong.), and Companies Issuing Face-Amount Certificates (H. Doc. No. 659, 76th Cong.).

Problems in connection with the investment company industry.—The record of the study of the Securities and Exchange Commission and the testimony taken before the subcommittee show there are various problems with respect to the organization and operation of investment companies which should be remedied by legislation. That this is so is recognized by representatives of the industry. The more important of these problems will be briefly summarized.

Basically the problems flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of public security holders. It is obvious that in the absence of regulatory legislation, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies and that deficiencies which have occurred in the past will continue to occur in the future.

The wide appeal to the public which has been made by investment companies in the past has been indicated in the testimony before the committee. It is evident that companies honestly and efficiently managed can serve a most useful purpose in extending to the public an opportunity to participate financially in the economic enterprise of the country. The committee believes that this bill will provide safeguards without undue restriction, so that those who desire to put their savings to work in this manner may do so with greater confidence.

Since no specified amount of capital is required to organize investment trusts and companies, they can be and have been created and their securities have been sold to the public in many instances by irresponsible individuals. Persons convicted or enjoined by courts

because of perpetration of securities frauds are able, nevertheless, to organize and operate investment companies. Brokers, security dealers, investment bankers, and commercial banks are in a position to dominate the board of directors and control the management of investment companies; and thus, when they are unscrupulous, to advance their own pecuniary interests at the expense of the investment companies and their security holders.

MANAGEMENT INVESTMENT COMPANIES

The capital structures of management investment companies have often been inordinately complex, and the rights, preferences, and dividend claims of senior securities have in many instances been inadequately safeguarded. By various devices of control, such as special voting stocks issued to distributors and managements, voting trusts, long term management contracts, control of the proxy machinery, and pyramiding of companies, public investors are effectively denied, in many instances, any real participation in the management of their companies.

The distribution and repurchase of the securities issued by investment companies have on occasion resulted in discrimination in favor of the management or other "insiders" who have been able to acquire the securities and to have the companies repurchase them on a basis more favorable than that accorded public stockholders. In the open-end companies the method of pricing their securities, which they are continuously selling and redeeming, may lead at times to substantial dilution of the investors' equity in the companies, and in some instances has even been used by persons closely connected with the companies to realize riskless trading profits.

A major problem in the case of management companies is created by the absence of any legal requirement for adherence to any announced investment policies or purposes. Such policies have often been radically changed without the knowledge or prior consent of stockholders. Similarly, after investors have invested in companies on their faith in the reputation and standing of the existing managements, control of the public's funds has frequently been transferred without the prior knowledge or consent of stockholders to other persons who were subsequently guilty of gross mismanagement of the companies.

The representatives of the investment trust industry were of the unanimous opinion that "self-dealing"—that is, transactions between officers, directors, and similar persons and the investment companies with which they are associated—presented opportunities for gross abuse by unscrupulous persons, through unloading of securities upon the companies, unfair purchases from the companies, the obtaining of unsecured or inadequately secured loans from the companies, etc. The industry recognized that, even for the most conscientious managements, transactions between these affiliated persons and the investment companies present many difficulties. Many investment companies have voluntarily barred this type of transaction.

The small investors in certain investment companies, particularly in unit investment trusts and open-end management companies, have been subjected to switching operations from one investment company to another to their pecuniary damage. Similarly, investors have been

often powerless to protect themselves against plans of reorganization which have been grossly unfair or have constituted gross abuses of trust on the part of their sponsors.

Finally, particularly with respect to those companies which have not registered their securities under the Securities Act of 1933 or the Securities Exchange Act of 1934, and only a small number has so registered its securities, the investor has been unable to obtain adequate information as to their operations. The accounting practices and financial reports to stockholders of management investment companies frequently are deficient and inadequate in many respects and ofttimes are misleading. In many cases, dividends have been declared and paid without informing the stockholders that such dividends represented not earnings but a return of capital to stockholders.

UNIT INVESTMENT TRUSTS

Certain abuses and deficiencies characterized particularly the unit investment or fixed trusts. These abuses are traceable to the fact that the most important emolument to the promoters of such trusts were the profits to be derived by the methods of pricing and selling the certificates of such trusts to the public. Inequitable pricing of shares, excessive sales loads, hidden loads, and charges have not been infrequent.

Furthermore, riskless trading profits and improper dilution of the investors' equity have not been unusual. The fixed trust shareholder was particularly subject to switching operations. Each of these switches invariably included additional loading charges exacted from the investor. Usually the trustee of the underlying assets of trusts would also cease its active connection with the trust, frequently because the rate of compensation was insufficient to sustain its interest in the trust. The result is that no responsible party is connected with the trust with whom the investor can deal. Certificate holders are thus left without any method of realizing on their certificates and the trusts become "orphans."

PERIODIC PAYMENT PLANS

Early in 1930 a somewhat novel variety of investment scheme, called variously "installment-investment plan," "periodic payment plan," "thrift plan," "foundation plan," etc., was conceived. These periodic payment plans are in essence devices for selling investment trust or investment company 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, etc. 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 his 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 market prices of these portfolio securities which almost invariably consisted of common stocks. The

purchaser of a periodic payment plan certificate is, therefore, speculating or investing in the stock market.

The structure of the periodic payment plan in most instances, but not in every instance, 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 percent to 20 percent. The Securities and Exchange Commission, in its report to the Congress on periodic payment plans, stated that the total loading charges, including trustees' fees and secondary loading charges, were 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 invested for his account. 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 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. In fact, the Securities and Exchange Commission reported to the Congress that well over 85 percent of the payments made by certificate holders of periodic payment plans was lost to them because of lapses during the first year. Approximately 40 percent of the total amount payable on periodic payment plan certificates sold in the period 1930–35 was lapsed at the end of 1935. The holders of periodic payment plan certificates were subject to a variety of switching operations resulting in profits to the sponsor and a loss to the investor by the exaction of another "secondary" sales load on the switches.

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 to the fact that persons unqualified to understand the intricacies of the plan were employed as salesmen, the committee was impressed by the evidence that salesmen often flagrantly misrepresented these plans. Fees were minimized or not disclosed. Undue emphasis was placed on the "trustee" and "trusteeships." The "trustee," whose functions were usually confined to holding title and custody of the underlying securities for the benefit of the certificate holder, was usually a large financial institution. Salesmen would show the balance sheets of these banks to prospects who would be advised that the trustee was back of and sponsored the plan. Thus, subscribers to these plans were apparently under the misapprehension that these large financial institutions actually guaranteed the so-called maturity value. Actually the trustee is in no way responsible for the operation

of the plan. Further supposed similarities between the plans and savings accounts and insurance and endowment policies were indicated. A "maturity value" or "termination value" which did not represent an obligation was placed on the installment plan certificate. Withdrawal and borrowing privileges were enlarged upon as salesmen analogized the periodic payment plans to savings bonds. Glowing predictions of wealth and financial independence were made. Emphasis was placed upon the "great" corporations, the common stock of which underlaid the installment plan. Not only was there a tendency to confuse the soundness of the "great" corporations with the soundness of the periodic payment plan, but many certificate holders were misled into believing that their money was directly invested in these securities rather than in interposed investment trust shares. Emphasis on the "savings" in the periodic payment plan literature was made in an effort to meet the sales resistance of a prospective purchaser to a speculative incursion into the investment field.

COMPANIES ISSUING FACE-AMOUNT INSTALLMENT CERTIFICATES

Face-amount installment certificates are, in essence, unsecured obligations to pay a specified amount to the holder at a specified future date provided the purchaser makes all the payments required by these contracts. The contracts after a certain number of prescribed payments have a cash surrender value—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 installments 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 installments 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 this obligation.

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.

The Commission's study has indicated that in certain cases obligations of face-amount companies with high improvement rates have been met despite changed conditions with lower prevailing interest returns on investments, through a combination of several factors. The lapse experience of investors was high, particularly during the first and second years when the investor had no surrender value or a surrender value substantially less than the total of the amount he had paid (although the certificates issued by some of the face-amount companies provided for reinstatement with credit for the amount paid in). The so-called "stretch-out" practice of depriving the investor pursuant to contract of any interest return on his entire investment

during any period in which he has been in default, 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. 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 this country.

NECESSITY FOR LEGISLATION

The committee has been greatly impressed with the sincerity and public-spirited attitude evinced by the representatives of the industry in participating in the formulation of this legislation. The committee, in recommending this regulatory legislation, does not mean to imply that most investment trusts and investment companies at present operating in this country were guilty of unfair practices or were mismanaged. Nor does it mean to indicate that in the last decade progress has not been made by the members of the industry voluntarily to eliminate some of the major abuses and deficiencies, and to improve generally standards of practice in the light of experience. However, the record does indicate that some of the grossest abuses were perpetrated in most recent years, in fact during the very course of the Commission's study. The conclusion is clear that the perpetrations of these misfeasances and the recurrence of these abuses cannot be completely abated nor the deficiencies eliminated without the enactment of adequate Federal legislation regulating these institutions. Virtually every representative of investment companies who appeared before the subcommittee conceded the necessity for, and in fact urged the immediate passage of, effective legislation to regulate investment companies. Practically no dissenting voice has been raised against any of the provisions of the substitute bill. In fact this bill has received the affirmative and unequivocal approval of the industry as a whole.

The Securities Act of 1933 and the Securities Exchange Act of 1934 have been ineffective to correct abuses and deficiencies in investment companies: first, because the record before the committee is clear that

publicity alone, which in general is the remedy provided by these acts, is insufficient to eliminate the abuses and deficiencies which exist in investment companies, and second, because a large number of such companies have never come under the purview of these acts. The representatives of the industry recognized that the protection of investors against unscrupulous management and the necessity for the prevention of the recurrence of the abuses disclosed by the Commission's study and the committee hearings made indispensable the immediate enactment of adequate legislation regulating investment companies. This is also the opinion of the committee, and the Securities and Exchange Commission concurs. Representatives of the industry have stated for the committee's record that they definitely feel that this bill (S. 4108) will materially abate, if not virtually eliminate, the malpractices and deficiencies in these organizations. They have urged that this legislation will serve the most salutary purpose of protecting small investors from breaches of trust; will afford investors a regulated and supervised institution in which to invest their savings; will act as an incentive for venture and risk capital; and will supply an intelligent and articulate group of stockholders in industrial and other public corporations. The industry asserted, and the Commission and the committee believe, that this legislation will tend to prevent those abuses which have been a stigma upon and impaired the usefulness of the investment trust industry as a whole.

Representatives of the Securities and Exchange Commission and of the industry who appeared at the hearings called the attention of the committee to the serious tax problem affecting investment companies. It appears that the nature of these companies in many respects, constituting a conduit for distribution of income to the smaller investor, is such that they should not be subjected to the same type of taxation as the ordinary business corporation. This has already been recognized in respect of certain classes of open-end companies which receive special tax treatment under existing Federal tax laws. The record before the committee indicates that the tax problem is acute with respect to closed-end companies of the type classified in this bill as "diversified". If this bill is passed, the committee believes that the tax problem of these companies should receive prompt consideration.

ANALYSIS OF PROVISIONS OF TITLE I

Findings and declaration of policy.—Section 1 of the bill contains the findings of the Congress with respect to investment companies and the declaration of policy of the bill.

Definitions and exemptions of investment companies.—Investment companies within the purview of this bill are in general defined as companies which are engaged primarily in the business of investing, reinvesting, and trading in securities; and issuers which invest in or hold securities (other than securities of non-investment company subsidiaries) having a value exceeding 40 percent of the value of their total assets. A third group of investment companies covered by the bill are companies which engage in the business of issuing so-called face-amount installment certificates. Provision is made generally to exclude from the bill companies primarily engaged, directly or through subsidiaries in the operation of a business other than that of an investment company. In addition the bill specifically excludes

brokers, underwriters, banks, insurance companies, common or commingled trust funds administered by a bank, bank holding company affiliates subject to the supervision of the Board of Governors of the Federal Reserve System, companies subject to the Interstate Commerce Act, and those of their wholly owned subsidiaries substantially all of whose assets consist of securities of companies which themselves are subject to the Interstate Commerce Act, small loan companies, factoring companies, companies dealing in mortgages or discount paper, holding companies subject to the Public Utility Holding Company Act of 1935, and certain other special types of companies (sec. 3). The bill makes provision for the exempting of employees' investment companies, and certain other persons who are not within the intent of the proposed legislation (sec. 6).

Classification and subclassification of investment companies.—Investment companies are broadly classified into three categories: management companies, unit investment trusts, and face-amount certificate companies. Management companies are divided into two types: open-end companies—companies in which the stockholder or certificate holder has a right to compel the company to redeem his shares at their asset value; and closed-end companies—companies in which the shareholders do not have such a right. Management companies, both of the open-end and closed-end type, are further subclassified upon the basis of the extent of the diversification of their investments, into diversified companies which, speaking generally, must have at least 75 percent of their assets in diversified securities and nondiversified companies which are not required so to diversify their investments (secs. 4 and 5).

Transactions by unregistered investment companies.—Investment companies, unless registered as provided in the bill, are forbidden to conduct their activities through use of the mails or instrumentalities of interstate commerce. Foreign investment companies may not register as investment companies or publicly offer securities of which they are the issuer in the United States unless the Commission finds that these foreign investment companies can be effectively subjected to the same type of regulation as domestic investment companies (sec. 7).

Registration of, disclosure of investment policy, and size of investment companies.—Provision is made for the registration of investment companies with the Commission. In the main, the Commission may require the information required to register securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. In addition, the registration statement must state the policy of the company as to items specifically enumerated in the bill and supply information with respect to the business affiliation and experience of the officers and directors of the company. Provision is made for the simplification of the registration procedure by permitting the filing of copies of registration statements already filed under the acts now administered by the Commission. No shift in the company's fundamental policies as stated in the registration statement may be made without the approval of a majority of the company's outstanding voting securities (secs. 8 and 13).

To put a brake on the irresponsible formation of investment companies, no investment company organized hereafter may make a public offering of its securities unless it has or is assured of having at

least $100,000 through private subscription. The bill does not contain any limitation with respect to maximum size of investment companies, but authorizes the Commission to study and report from time to time the effect of size of investment companies both on the national economy and on the trusts themselves (sec. 14).

Ineligibility of certain affiliated persons and underwriters.—Any person, who within 10 years has been convicted of a crime or is enjoined by a court in connection with a security or financial fraud is prohibited by the bill from acting as an officer, or director, of any investment company or in certain other capacities. The bill recognizes, however, that even such a person may rehabilitate himself and so the Commission is authorized to exempt persons from this prohibition where it is shown that the penalty as applied to any such person would be unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors that such exception be granted (sec. 9).

Provisions relating to directors, officers, and certain affiliated persons.—In the future, no person shall serve as a director of an investment company unless elected by the holders of its outstanding voting securities, except that, in effect, vacancies not exceeding one-third of the board occurring between meetings of stockholders may be filled in any otherwise legal manner. However, with respect to existing strict trusts, where no provision is made for election of trustees, the bill does not require an affirmative election of trustees but provides a procedure for their removal by certificate holders (sec. 16).

The bill provides that at least 40 percent of the board of directors of an investment company shall be "independent"; that is, no more than 60 percent may consist of investment advisers to the company or affiliated persons of such an adviser or officers or employees of the company. Moreover, a majority of the board of directors of an investment company must be composed of persons who are not regular brokers for the company or principal underwriters of its securities, or investment bankers, or in each case persons affiliated with them. An exception is made to take care of certain types of investment companies which are closely affiliated with investment advisers and which are designed primarily to make available this medium of diversification of investment to the smaller customers of these advisers. This exception is carefully safeguarded by specific conditions. Hereafter the majority of the board of directors of an investment company may not consist of persons who are officers or directors of any one bank, except that any investment company which, on March 15, 1940, shall have had a majority of its directors consisting of such persons may continue to do so (sec. 10).

In the future, persons who are officers, directors, investment advisers, etc., or persons affiliated with such persons may not, as principal, knowingly sell to or purchase from any investment company any securities or other property or borrow from any such investment company. Provision is made for certain exceptions with respect to transactions involving the company's own security issues and for transactions exempted by the Commission (sec. 17).

In general, agency transactions are not affected by the bill, but brokerage commissions are limited in the main to standard rates

with provision for special exemptions. Provision is made that those officers and employees who have access to securities or funds of investment companies may be required to be bonded. Securities of investment companies must be placed in the custody either of banks, or with stock exchange firms subject to supervision by the Commission as to methods of safekeeping (sec. 17).

Investment companies may not purchase securities underwritten by persons affiliated with the investment company, unless the investment company itself is a principal underwriter of such securities, until after the termination of the underwriting syndicate (sec. 10). Officers and directors of investment companies and certain other persons are not allowed to exculpate themselves from liability for any wilful misfeasance, bad faith, gross negligence, or reckless disregard of their duties (sec. 17). The provisions of section 16 of the Securities Exchange Act of 1934 relating to transactions of officers, directors, and controlling persons which now apply to equity securities of investment companies whose securities are listed on a national securities exchange are made applicable to all securities of all registered closed-end companies (sec. 30). Gross misconduct or gross abuse of trust by directors, officers, investment advisers, principal underwriters, etc., is made a basis for injunctive proceedings in a Federal court to be instituted by the Commission (sec. 36). Larceny or embezzlement of property of investment companies is made a Federal crime (sec. 37).

Provisions with respect to certain activities of investment companies.—Investment companies, generally speaking, may not trade on margin, participate in joint trading accounts, or effect short sales in portfolio securities in contravention of rules and regulations which may be prescribed. Investment companies may engage in underwriting activities if consistent with their declared investment policies (sec. 12). Upstream loans to investment companies, except by wholly owned subsidiaries, are prohibited (sec. 21).

Hereafter, an investment company or group of controlled companies may not purchase securities issued by another investment company if as a result of such acquisition such group will have more than 3 percent of the outstanding voting securities of such other investment company, or 5 percent of a specialized investment company. Investment companies, however, may increase their holdings in other investment companies of which they already hold 25 percent of the voting stock, since such holdings constitute presumptive control. A similar provision limits the acquisition by investment companies of an insurance company's stock to 10 percent, with additional exceptions relating to the organization of new insurance companies and the purchase of stock of insurance companies from other investment companies or where it is found that such acquisition is in the public interest because the financial condition of such insurance company will be improved as a result of such acquisition or any plan contemplated as a result thereof (sec. 12).

Cross and circular ownership as defined are prohibited in the future and existing cross and circular ownership must be eliminated within 5 years (sec. 20).

Although investment companies are in general prohibited from acquiring securities of persons engaged in the brokerage business or in the business of underwriting and dealing in securities, provision is made to permit investment companies, either alone or jointly with other investment companies, to purchase stock of a company engaged

primarily in the business of underwriting and distributing securities and to acquire stock of a company formed to engage in the business of furnishing new capital to industry, financing promotional enterprises and similar activities (sec. 12). It is hoped that investment companies will soon jointly form such a company. It is believed it should make a material contribution to national recovery.

Distribution, repurchases, and redemptions of investment company securities.—No open-end company and no closed-end company may issue any of its securities except for cash or for securities (secs. 22 and 23).

Publicly offered securities of all investment companies must be registered under the Securities Act of 1933, but provision is made to eliminate duplication in the material filed under that act and the present bill. Circular literature intended for distribution to prospective purchasers of the securities of open-end companies, unit investment trusts, and face-amount certificate companies must be filed with the Commission (sec. 24).

Closed-end companies may not issue their common stock at a price below the current net asset value, except in connection with an offering to their security holders, conversion of a convertible security, exercise of any warrant outstanding on the date of enactment of this bill, or with consent of a majority of their stockholders. No closed-end company may repurchase any of its outstanding securities except on a securities exchange or open market upon prescribed notice to its stockholders or pursuant to tenders or under other circumstances to be prescribed to insure fair treatment of all security holders (sec. 23).

With respect to the distribution and redemption of securities issued by open-end companies, an association of securities dealers registered under section 15A of the Securities Exchange Act of 1934 is, subject to the provisions of that section, empowered to make rules to protect investors, so far as is reasonably practicable, against any dilution of their equity due to the methods of pricing, distribution, and redemption of redeemable securities and to prevent grossly excessive sales loads on such securities. The Commission after 1 year is empowered to make rules and regulations to deal with these subjects. In other words, the industry is given a year in which to solve this problem for itself. In addition, provision is made to prohibit the sale of redeemable securities to any person other than a dealer or principal underwriter at a price less than that at which the security is sold to the public. The bill prohibits the suspension of redemption of a redeemable security for a period more than 7 days except during certain specified emergency periods or other period fixed by the Commission. The negotiability of open-end securities may not be restricted in contravention of provisions which may be formulated (sec. 22).

Capital structure.—Except for refunding of outstanding securities and securities issued in connection with reorganizations, closed-end companies in the future may not issue more than three classes of securities—one class of security representing indebtedness (including loans not publicly distributed), one class of preferred stock and one class of common stock. Securities representing indebtedness must have at the time of issue an asset coverage of at least 300 percent and preferred stock an asset coverage of at least 200 percent. Similarly no dividends or distributions may be declared or made upon the common stock unless the securities representing indebtedness and preferred

stock issued in the future have an asset coverage of 300 percent and 200 percent respectively, and dividends may not be paid on such preferred stock unless such indebtedness has an asset coverage of at least 200 percent. Voting rights are also provided for preferred stock and in certain contingencies for senior securities representing indebtedness other than loans. Temporary borrowings up to 5 percent are exempted from this provision (sec. 18).

Open-end investment companies are not permitted to issue any senior securities, except that such companies are permitted bank borrowings provided that an asset coverage of 300 percent is maintained at all times for such borrowings (sec. 18).

Dividends.—In respect of dividends on existing securities, as well as securities issued in the future, investment companies are required to disclose by written statement accompanying any dividend the source of such payment when made other than from the current or accumulated net income as defined (sec. 19).

Proxies and voting trusts.—Solicitations of proxies, consents, and authorizations relating to securities of investment companies registered under this bill are to be subject to the regulations to which solicitations relating to securities listed on national securities exchanges are already subject by reason of the Commission's regulations adopted under section 14 (a) of the Securities Exchange Act of 1934. To assure uniformity of interpretation and administration as between that act and the present bill, section 20 (a) of the bill has been so drafted as to follow verbatim section 14 (a) of the Securities Exchange Act, with only such slight modifications of language as are necessary because of the special classes of companies to which section 20 (a) applies.

Hereafter, no public offering may be made of voting trust certificates of investment companies. Existing voting trusts may continue until their expiration (sec. 20).

Investment advisory contracts and contracts for distribution of open-end company securities.—After 1 year from the effective date of the act all investment advisory or management contracts must be in writing, must prescribe in detail the compensation to be paid, and must be nonassignable and terminable upon 60-days notice. In effect, the contract has to be approved by a majority of the voting stock, may be for an initial period of 2 years, and renewable annually thereafter by the board of directors or stockholders. Analogous provisions are incorporated with respect to contracts for the distribution of open-end company securities. Existing arrangements are permitted to continue for a period not exceeding 5 years (section 15).

Reorganizations of investment companies.—With respect to investment company reorganizations as defined, the bill provides that the Commission, at the request of 25 percent of any class of the security holders to be affected by such reorganization, or on the request of a company which is a party to such a plan, may give an advisory opinion. The company is required to send a copy of such advisory opinion to its security holders. The Commission may institute injunction proceedings in a Federal Court to restrain the consummation of grossly unfair plans of reorganization or plans which constitute gross misconduct or gross abuse of trust (sec. 25). The functions and duties of the Securities and Exchange Commission under the Bankruptcy Act remain unchanged.

Reports and accounting.—Investment companies are required to file with the Commission annual reports, including financial statements, similar to the annual reports now filed with the Commission under the Securities Exchange Act of 1934 by companies having securities listed on national securities exchanges, and less comprehensive reports on a semiannual or quarterly basis. In addition, investment companies must file with the Commission copies of reports sent to their security holders and may be required to transmit semiannually to their stockholders reports containing certain specified financial and other information. The reports to stockholders may not be misleading in any material respect in the light of the reports filed with the Commission. Under other acts administered by the Commission, lacking such a provision as this, misleading financial statements, inconsistent with those filed with the Commission, have been sent security holders in an appreciable number of instances. Annual reports to the Commission and to stockholders may be required to be certified by independent public accountants, whose certificate must be based on a reasonably comprehensive audit (sec. 30).

The Commission is authorized to require investment companies and certain of their majority-owned subsidiaries to preserve accounts, records, and documents upon which the financial statements filed with the Commission are predicated. Investment advisers, depositors, and principal underwriters of certain investment companies may likewise be required to preserve records showing their transactions with the investment companies with which they are associated. These accounts, records and documents are subject at all times to examination by the Commission or its representatives. The Commission is authorized to provide for a reasonable degree of uniformity in the accounting policies and principles to be followed by investment companies in maintaining their accounts and records and preparing the financial statements required in their reports to the Commission and stockholders (sec. 31).

Subject to certain exceptions, the selection of independent public accountants of investment companies must be submitted for ratification or rejection to stockholders who, in addition, at any time by a majority vote may terminate their employment. The auditor's certificate must be addressed to security holders as well as the directors. The controller or other principal accounting officer of every company is to be chosen either by the board of directors of the company or by its security holders, and not merely be appointed by its executive officers. The Commission is also empowered to require accountants and auditors to keep reports and work sheets and other documents relating to investment companies (sec. 32).

Unit investment trusts.—The trust indentures of unit investment trusts must designate as trustee or custodian a bank of a specified minimum size; must require that all property and funds of the trust will be held by the trustee; and that the trustee (which may not resign unless a successor trustee has been designated or the trust liquidated) be entitled to reimburse itself out of the trust property for its expenses actually incurred and fees actually earned. Except under special circumstances, the depositor or underwriter must be prohibited from deriving any fees from the trust other than the original sales load for distributing the shares. Provision must also be made to advise shareholders of portfolio changes. Finally, proceedings in court may be

instituted by the Commission to liquidate so-called orphan trusts (sec. 26).

Periodic payment plans.—The bill contains additional provisions which relate specifically to companies issuing periodic payment plan certificates. These provisions fall roughly into three classes: provisions relative to sales load; provisions regulating the incidents and denominations of the certificates, and provisions regarding custodianship. The sales load is limited to 9 percent. Recognizing the heavier initial expense, due primarily to sales commissions, the bill permits half of the sales load to be taken out during the first year of the plan; the balance is to be spread equally over the subsequent years. To prevent evasion of these restrictions on sales load by the imposition of so-called management fees, the Commission is authorized to prescribe maximum management fees. The provision relating to sales load may be modified by the Commission to meet the problems of small companies. Periodic payment plan certificates must be redeemable securities; and the initial payment under any plan must be at least $20, with each subsequent payment at least $10 (sec. 27).

Face-amount certificate companies.—Companies which sell face-amount certificates are generally subject to the provisions of the bill but must comply with certain provisions which are specifically applicable to that type of company. The bill contains provisions with respect to minimum capitalization of face-amount certificate companies. All companies which in the future sell these certificates must at all times maintain reserves, which, accumulated at a rate not to exceed 3½ percent compounded annually, must provide an amount sufficient to meet at all times all the liabilities and obligations of the company to all its certificate holders. The companies must have cash or qualified investments (investments which are qualified under the Code for the District of Columbia for life insurance companies) of a value not less than the aggregate of their capital and reserve requirements. The bill makes provision to require deposit with certain qualified banks all or any part of the investments maintained by such company as certificate reserve requirements except that the company may be credited with deposits made pursuant to law or regulation with State authorities in respect to liabilities of the certificates sold to the residents of such States. The bill makes provision for the distribution of the loading charge (the maximum amount of which charge is fixed by the bill) over the life of the certificate. In essence, no more than 50 percent of the load may be taken out the first year, no more than 7 percent in each of the following 4 years, and not more than 4 percent the remaining years. The surrender value of the certificate for the first year must be equal to at least 50 percent of the gross annual payment made on the certificate and for any subsequent time must be the amount of reserve of such certificate less a prescribed surrender charge. A certificate may not contain a provision making the holder liable for any unpaid balance on the certificate and must provide for the issuance to the certificate holder upon the happening of certain contingencies of a so-called paid-up certificate.

The obligations of the company to a certificate holder, who has defaulted, are specifically enumerated in the bill (sec. 28). If a face-amount company does not maintain the minimum certificate

reserve on all its outstanding face-amount certificates issued prior to the effective date of the bill then the company cannot make any distribution or pay any dividend on any senior capital security which exceeds a prescribed percentage of its earnings or which the Commission determines might impair the financial integrity of the company or its ability to meet its liabilities on the outstanding certificates. In the future, face-amount certificate companies cannot issue senior capital securities in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate for the protection of investors, or if such company has such senior capital securities outstanding to make any distribution or pay any dividend in contravention of such rules and regulations as the Commission may prescribe to insure the financial integrity of the company and to prevent the impairment of the company's abilities to meet its obligations on its face-amount certificates (sec. 18). A face-amount company can acquire the securities of another face-amount company only upon certain prescribed conditions (sec. 12). The bill makes provision to obtain equality of treatment of certificate holders who are residents of various States in the event of bankruptcy of a face-amount company. The bill preserves the rights of residents in those States which require specific deposits with their State officials but makes provision for equalization of treatment of all certificate holders, by providing that residents of other States must receive an amount equal to that received by the residents of States with deposits, before the latter can share in the general assets of the bankrupt company (sec. 29).

Unlawful representations.—The bill contains the usual provisions prohibiting misrepresentations and half-truths in registration statements, reports and other documents filed with the Commission, and prohibiting the misrepresentation of the effect of registration with the Commission. In addition, the use of misleading names by registered investment companies is specifically prohibited. The latter provisions may be enforced by order of the Commission when the name is adopted after the effective date of the bill, and by a court at the suit of the Commission as to names theretofore adopted (secs. 34 (b), 35).

Administrative and enforcement machinery.—The bill contains ample provisions, but appropriately circumscribed, for the enforcement of its provisions; for the carrying out of the powers and duties vested in the Commission, and for court review of the Commission's action (secs. 38 to 46, 49).

Formal provisions.—The bill contains the usual provisions regarding validity of contracts, liability of controlling persons, the effect of the bill on existing law, and separability of provisions. The effective date of title I is November 1, 1940, as to all companies except face-amount certificate companies, as to which the bill does not become effective until January 1, 1941. The short title of the bill is the "Investment Company Act of 1940" (secs. 47, 48, 50 to 53).

Title II. Investment Advisers

Title II, which deals with investment advisory services, is an outgrowth of the Commission's survey of these organizations in connection with its study of investment trusts and investment companies.

The subcommittee held hearings on the original provisions of title II as they were included in S. 3580. At these hearings representatives of the larger investment adviser firms and representatives of a voluntary association of investment advisers opposed that title. However, at the conclusion of the hearings, much as in the case of the investment trusts and investment companies, representatives of the investment adviser organizations and the Securities and Exchange Commission, at the suggestion of the chairman of the subcommittee, conferred with a view to drafting proposals which would have the support of the investment advisers and the Commission. As a result, title II of S. 4108 was prepared. This title has the affirmative support of virtually all investment advisers, both the members of the association and those who are not members, who appeared before the committee.

GENERAL STATEMENT

Investment advisers are persons who for compensation engage in the business of advising others, either directly or through publication or writings as to the value of securities, or as to the advisability of investing in, purchasing, or selling securities or who for compensation and as part of a regular business issue or promulgate analyses or reports concerning securities.

The emergence of the investment adviser as an important occupation or profession did not occur until the World War. However, it was not until after 1929 that the investment adviser firms organized and increased rapidly. The number of investment advisers presently functioning has been difficult to ascertain. The Commission reported to the Congress that in connection with its study of these firms, it obtained replies to questionnaires from only 394 persons or firms which administer funds or give investment advice.

Similarly, it is difficult definitely to estimate the amount of funds under the influence or control of investment advisers. However, some idea of the size of the funds administered by investment advisers may be deduced from the fact that 51 firms for which information was obtainable by the Commission managed, supervised, and gave investment advice with respect to funds aggregating approximately $4,000,000,000.

The nature of the functions of investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this committee that protection of investors requires the regulation of investment advisers on a national scale.

The report of the Commission to the Congress and the record before the committee is clear that the solution of the problems and abuses of investment advisory services—individuals and companies which either handle pools of liquid funds of the public or give advice with respect to security transactions—cannot be effected without Federal legislation.

Not only must the public be protected from the frauds and misrepresentations of unscrupulous tipsters and touts, but the bona fide investment counsel must be safeguarded against the stigma of the activities of these individuals. Virtually no limitations or restrictions exist with respect to the honesty and integrity of individuals who may solicit funds to be controlled, managed, and supervised. Persons

who may have been convicted or enjoined by courts because of perpetration of securities fraud are able to assume the role of investment advisers. Individuals assuming to act as investment advisers at present can enter profit-sharing contracts which are nothing more than "heads I win, tails you lose" arrangements. Contracts with investment advisers which are of a personal nature may be assigned and the control of funds of investors may be transferred to others without the knowledge or consent of the client.

Title II recognizes that with respect to a certain class of investment advisers, a type of personalized relationship may exist with their clients. As a consequence, this relationship is a factor which should be considered in connection with the enforcement by the Commission of the provisions of this bill.

ANALYSIS OF PROVISIONS OF TITLE II

Findings and definitions.—Sections 201 and 202 contain, respectively, the findings of the Congress with respect to investment advisers and the definitions of various terms used in title II. The term "investment adviser" is so defined as specifically to exclude banks, bank holding company affiliates, lawyers, accountants, engineers, teachers, brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions), publishers of bona fide newspapers, news magazines, or financial publications of general and regular circulation, and persons whose advice is limited to securities issued by the United States and certain instrumentalities of the United States. In addition, the Commission is authorized by rules and regulations or order, to make certain further exceptions according to prescribed statutory standards.

Registration of investment advisers.—Investment advisers who make use of the mails or instrumentalities of interstate commerce in connection with their investment advisory business, unless they fall within one of the specific exemptions provided in section 203 (b), are required to register by filing with the Commission an application for registration containing certain information, the character of which is specified in the bill. The administrative machinery for registration is similar to that provided in the Securities Exchange Act of 1934 for the registration of over-the-counter brokers and dealers. Registration may be denied or revoked if the registrant has within 10 years been convicted of a crime or is enjoined by a court in connection with a security or financial fraud, or if his application for registration is materially misleading. The data contained in the application for registration must be kept reasonably current by such annual and special reports as the Commission may require for that purpose (secs. 203, 204).

Investment advisory contracts.—Contracts or agreements between an investment adviser and a client may not provide for compensation to the investment adviser based upon capital gains or capital appreciation. Each such contract must be non-assignable, and must provide, if the investment adviser is a partnership, that the client will be notified of any change in the membership of the firm, so that he will be in a position, if he so desires, to disaffirm the contract (sec. 205).

Certain prohibited transactions.—Transactions and practices which defraud or operate as a fraud or deceit upon clients or prospective clients are prohibited. Registered investment advisers are also for-

bidden to purchase securities from or sell securities to any client, either as principal or in connection with a brokerage business, without first advising the client of the transaction and obtaining his consent thereto (sec. 206).

Unlawful representations, administrative and enforcement machinery, and formal provisions.—In these respects title II contains provisions generally comparable to those of title I (sec. 207 to 221, inclusive). Section 210, which relates to publicity, recognizes that in many instances the adviser-client relationship has a confidential basis, and provides for confidential treatment of information obtained in the administration and enforcement of the title, to the extent that such treatment is consistent with efficient enforcement.