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## THE INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940<sup>1</sup> is the least known of the six statutes principally administered by the Securities and Exchange Commission.<sup>2</sup> However, in spite of this lack of notoriety, the great importance of the Act can be fully appreciated in the light of the precarious position of the investor both before and since the passage of the Act. It is the purpose of this comment to examine the practices which demanded legislation for the protection of investors, to measure the effectiveness of the present Act, and to propose legislation to eliminate weaknesses of the Act and provide further safeguards for the investor.

The first known reference to investment advisers seems to have preceded the advisers themselves. In 1897 the *Nation* sounded a clarion call for a new profession on the ground that "there ought to be men as well qualified to certify to the merits of railroad bonds as the men who now certify to the merits of land-titles."<sup>3</sup> The editorial concluded with the view that "the public can well afford to pay those who are able to save it from throwing away its money in dishonest and badly managed enterprises."<sup>4</sup>

The first investment advisory organization was formed in 1899<sup>5</sup> in New York City, and only ten firms were organized before 1919.<sup>6</sup> Prior to 1919 investment advice was furnished, but as an incident to a regularly established business or profession. "Lawyers, banks and trust companies, brokers and dealers in securities, in the course of their business furnished investment advice to their clients, depositors and customers."<sup>7</sup> Such ancillary service seems to have met the need until shortly after the first World War when the separate existence of the investment adviser became assured.<sup>8</sup> This trend has been authoritatively explained as due to the greatly increased public participation in securities investment and the consequent need of advice by

1. 54 STAT. 789, 847, 15 U.S.C. § 80b-1 (1940). The Act is divided into three titles and this comment is limited to Title II which is separately known as the Investment Advisers Act of 1940. Title I regulates investment companies and is separately known as the Investment Company Act of 1940. See Comment, *The Investment Company Act of 1940*, 50 YALE L. J. 440 (1941). Title III amends § 8(a) of the Securities Act of 1933, 48 STAT. 74 (1933), 15 U.S.C. § 77a (1940).

2. The other five statutes principally administered by the Securities and Exchange Commission are: the Securities Act of 1933, 48 STAT. 74 (1933), 15 U.S.C. § 77a (1940); the Securities Exchange Act of 1934, 48 STAT. 881 (1934), 15 U.S.C. § 78a (1940); the Public Utility Holding Company Act of 1935, 49 STAT. 803 (1935), 15 U.S.C. § 79 (1940); the Trust Indenture Act of 1939, 53 STAT. 1149 (1939), 15 U.S.C. § 77aaa (1940); and the Investment Company Act of 1940, 54 STAT. 789, 15 U.S.C. § 80a-1 (1940).

3. Editorial, *A New Profession*, *The Nation*, Aug. 26, 1897, p. 162, col. 3.

4. *Id.* at 163, col. 1.

5. REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1939) c. 6, p. 27. (Hereafter cited as SEC REPORT.)

6. SEC REPORT, c. 2, p. 3.

7. *Ibid.*

8. SEC REPORT, c. 2, p. 4.

those whose limited means and primary occupation with other endeavors precluded their possessing the requisite information to rely on their own judgments.<sup>9</sup> Prior to the first World War the general public was interested in a much smaller number of securities than it has been subsequently, and at that time the bulk of general securities issues was purchased by institutional investors such as commercial banks, insurance companies, and trustees.<sup>10</sup> The selling campaigns for the Liberty Bond issues tapped a capital market which private industry had never been able to reach. After the termination of Government issues on such a large scale these new buyers retained their interest in securities and furnished a new capital market for privately issued stocks and bonds.<sup>11</sup> The post war market boom in stocks was another important factor in attracting those who had previously put their liquid assets in savings banks and local investments about which they had personal knowledge.<sup>12</sup> When these investors entered the nation-wide capital market they lacked accurate and detailed information. The reputable investment adviser or counsellor attempts to aid those participants in the securities market who feel that they need independent, unbiased technical advice.<sup>13</sup> The ideal is to furnish advice analogous to that furnished by the lawyer on a legal problem.<sup>14</sup>

In spite of the need for competent technical advice, growth in the number of advisers was slow.<sup>15</sup> Only thirty-six of the three hundred ninety-four investment counsel firms which the Securities and Exchange Commission studied in 1939 were formed between 1920 and 1929.<sup>16</sup> Beginning in 1929 the number of new firms in the business increased rapidly. There were three hundred thirty-four new firms formed between 1929 and 1937.<sup>17</sup> This very substantial increase was at least partly attributable to the cautiousness of the investing public following the stock market crash of 1929. The public felt that supervision of its security investments was necessary.<sup>18</sup>

There were many questionable business methods which could be used by advisers prior to the passage of the Act. In 1939, it was not uncommon for an adviser to arrange that one client buy a certain security and that another sell the same one.<sup>19</sup> Where the adviser operated on the then commonly accepted basis of receiving a proportion of profits made by his clients, he could not lose

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9. *Ibid.*

10. *Ibid.*

11. *Ibid.*

12. *Ibid.*

13. Article, *Buy; Hold; Sell*, *Business Week*, Oct. 3, 1936, p. 22, col. 2.

14. See the *Code of Professional Practice* adopted by the Investment Counsel Association of America which is reprinted in SEC REPORT, Appen. G, p. 65.

15. SEC REPORT, c. 2, p. 5.

16. *Ibid.*

17. *Ibid.*

18. Latest figures list 853 advisers. 12 SEC ANN. REP. 101 (1946).

19. Porter, *New Bait for Suckers*, *American Magazine*, July, 1939, p. 14, col. 2.

by using this technique.<sup>20</sup> The adviser's sole concern was to seek new clients to replace those whose assets or credulity were exhausted. Adviser custody of clients' funds was the basis of most deceptive practices.<sup>21</sup> Instead of buying and selling in the interest of the client there was frequently a shifting of high quality securities to the adviser's personal account and the placing of his unwanted issues in the client's account.<sup>22</sup> These basic practices and the infinite variations thereof resulted in the passage of the Investment Advisers Act of 1940.<sup>23</sup> It is significant that the reputable advisers supported the measure.<sup>24</sup>

#### THE ACT AND PROPOSED AMENDMENTS

The reasonably vigilant investor can be expected to take the trouble to ascertain that one from whom he seeks advice is properly registered with the Securities and Exchange Commission.<sup>25</sup> Having done this, is he in a position to view with approbation and confidence the one who properly holds himself out as "registered with the Commission"?<sup>26</sup> Does he have assurance that the investment adviser of his choice is qualified in any way to give the advice for which he expects to be paid? In order to answer these questions it is desirable to look at the practices which are as prevalent today as they were prior to the passage of the Act.<sup>27</sup> Advisers' methods range all the way from orthodox business methods to astrology.<sup>28</sup> One adviser has done very well financially by selling advice based on his dreams.<sup>29</sup> Some advisers use plain guesswork or hunches, although a recent survey states that "most" of the business uses accepted economic methods and research.<sup>30</sup> The extremely technical wing of

20. *Ibid.*

21. *Id.* at p. 142, col. 2.

22. *Id.* at p. 14, col. 1.

23. "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." SEN. REP. No. 1775, 76th Cong., 3rd Sess. (1940).

24. "As now drafted, the title has the approval and endorsement of the investment advisers who appeared at the hearings before the committee. In addition the title is unqualifiedly endorsed by the Investment Counsel Association of America and by a large number of investment advisory organizations which did not testify before the congressional committee." H. R. REP. No. 2639, 76th Cong., 3rd Sess. (1940).

25. The Securities and Exchange Commission is hereafter referred to as the Commission.

26. Section 208(b) of the Investment Advisers Act of 1940 permits such a statement providing that it is true in fact and that its effect is not misrepresented. (Hereafter the Investment Advisers Act of 1940 is referred to as the Act except when the full name is used. Sections of the Act are hereafter cited by section number only in the text and footnotes.)

27. Article, *Goal: sell high, buy low*, Fortune, March, 1947, p. 146, col. 3.

28. SOWARDS, STOCK MARKET PRIMER 60.

29. *Ibid.*

30. Article, *Goal: sell high, buy low*, Fortune, March, 1947, p. 146, col. 3.

the business starts and ends with economic analysis of the market itself.<sup>31</sup> All of these advisers are attempting to solve the two basic problems of timing and selectivity, or when and what to buy and sell.<sup>32</sup> The success of an investment counsellor can be measured by how well he does both.

Section 201 of the Investment Advisers Act states the relationship between the activities of investment counsel and the national securities exchanges and interstate over-the-counter markets, which since 1934 have been subject to federal control. The Congress found that investment advisers are of national concern because, among other reasons, their activities occur in such volume as to affect substantially interstate commerce and the national economy. There is but little doubt that the S.E.C. Report of 1939 was influential in achieving passage of the Act.<sup>33</sup>

Section 202 defines terms used in the Act. Section 202 (a) (11) is the most important definition and deserves consideration in detail as it delimits the scope of the Act. An investment adviser is "any person"<sup>34</sup> who directly or indirectly is principally engaged in the business of advising as to the value of securities or as to the advisability of investing in securities in return for compensation.<sup>35</sup> Specifically exempted from this category are the following: banks and certain of their holding company affiliates;<sup>36</sup> lawyers, teachers and others whose advice is only incidental to their business;<sup>37</sup> general or financial newspapers and magazines;<sup>38</sup> and those whose advice pertains only to certain securities exempt under the Securities Exchange Act of 1934.<sup>39</sup> There is also blanket provision for exemption by order of the Commission of

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31. The accepted emphasis is decidedly on the long run economic analysis. "The present analysis of the situation from the point of view of the clientele of the investor's services is believed to disclose the true nature of the unsoundness of the short-term point of view as an investment policy. Short-term objectives are unsound for the investing public because they are not attainable by the average investor, and never can be." Kerchner, *Possibilities and Limitations of Investor's Services*, 1936, p. 42, Private Edition distributed by the University of Chicago Libraries. Reprinted from the *Journal of Business of the University of Chicago*, Vol. X, No. 4, 1937, and Vol. XI, No. 1 (1938). Thoughtful analysis of economic forecasting in the advisory field recognizes its limitations. "In the light of this study scientific economic forecasting seems to consist in the statement of that which may be known concerning the future, much or little as it may be, after study of the enduring or recurring qualities of things, and the enduring or recurring forces or tendencies which affect economic events. It does not consist in predicting the occurrence of particular events at certain times and places, because particular economic events may be affected, to some extent, by unknown forces as well as by known forces or tendencies. In short, scientific forecasting might be defined as the search for knowledge pertaining to the future and the statement of that which is known concerning the future in such general or qualified terms as to avoid embracing something which is not known." *Id.* at 43.

32. Article, *Goal: sell high, buy low*, *Fortune*, March, 1947, p. 146, col. 3.

33. See SEN. REP. No. 1775, 76th Cong., 3rd Sess. (1940).

34. These words include an individual and also any form of business organization. 10 SEC ANN. REP. 179 (1944).

35. Section 202 (a) (11).

36. Section 202 (a) (11) (A).

37. Section 202 (a) (11) (B).

38. Section 202 (a) (11) (D).

39. Section 202 (a) (11) (E).

others who are "not within the intent of this paragraph."<sup>40</sup> Pursuant to this subsection the Commission has by order excluded from the operation of the Act a corporation which rendered advice exclusively to banks and trust companies which together own all of the stock of the corporation and where the corporation is subject to the supervision of the Board of Governors of the Federal Reserve System and the Comptroller of the Currency.<sup>41</sup> Where the same corporation has proposed that it be allowed to remain exempt from the Act when, incidental to its main purpose, it assists the banks in furnishing their individual customers with investment advice, there is some doubt as to whether it should remain exempt.<sup>42</sup> The final decision will probably be based on the "frequency or importance"<sup>43</sup> of advice rendered to individual bank customers. In the same way a corporation which exclusively renders investment advice to mutual savings banks within one state is excluded.<sup>44</sup> The Commission has by order excluded a corporation of which all of the stock is owned by a bank holding company affiliate as defined in the Banking Act of 1933,<sup>45</sup> which corporation renders investment advice exclusively to banks and trust companies, a majority or substantial amount of the stock of which is owned by the same bank holding company affiliate, because such corporation is not within the intent of the Act.<sup>46</sup> Where a family corporation renders investment advice only for the benefit of the members of a single family and their enterprises, it is excluded from the Act because it "has not conducted and does not propose to conduct any investment advisory business with the general public."<sup>47</sup> This reasoning can obviously be made the basis for exclusion of those who do not come within the meaning and intent of the Act. It has already been extended to cover the incidental advisory activities of the professional trustee.<sup>48</sup>

A special problem exists in connection with the interpretation of Section 202(a)(11)(C)<sup>49</sup> in view of the practice of some brokers who are not members of a national securities exchange. The problem arises where such a non-member broker transmits to a broker who is a member of such an exchange an order to execute a transaction on a national securities exchange for

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40. Section 202(a)(11)(F).

41. In the Matter of Marine Midland Group, Inc., 8 S.E.C. 154 (1940).

42. In the Matter of Marine Midland Group, Inc., Investment Advisers Act of 1940 Release No. 45, Sept. 4, 1946.

43. *Ibid.*

44. In the Matter of Savings Bank Association of Maine, 8 S.E.C. 826 (1941).

45. 48 STAT. 162 (1933), 12 U.S.C. § 21.

46. In the Matter of First Service Corporation, 8 S.E.C. 152 (1940).

47. In the Matter of Donner Estates, Inc., 10 S.E.C. 400, 401 (1941).

48. "Any advice given by applicant to others as to securities is solely incidental to his activity as professional trustee." In the Matter of Loring, 11 S.E.C. 885, 887 (1942).

49. Section 202(a)(11)(C) provides for exclusion from the terms of the Act of "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."

the account of a customer of the non-member broker and charges his customer a "service charge" or a commission which is in addition to the one which the member-broker receives for executing the transaction. If such an additional commission is charged, it may possibly be regarded as the receipt of "special compensation" within the meaning of Section 202(a)(11)(C). A letter from the General Counsel of the Commission to the National Association of Security Dealers recommends to the latter's members that they register as investment advisers pending determination of the question.<sup>50</sup> The General Counsel recognizes that the answer may vary depending upon the relationship between the extra commission and the advice rendered.<sup>51</sup> Apparently there would be a difference between a situation where the extra commission was uniformly imposed on all customers without regard to advisory service and one where the charge is imposed only on customers who seek advice, its amount varying with the amount of advice they have received.<sup>52</sup> The desired distinction is to exclude the broker or dealer who renders advice incidentally and at the same time not to allow this exclusion to result in the rendering of investment advisory services as such for special compensation.

It is believed that the scope of the Act as enunciated in Section 202(a)(11) is adequate in covering all those who are primarily engaged in the investment advisory business.

Unless he is registered with the Commission under Section 203, it is unlawful for any investment adviser "to make use of the mails or any means or instrumentality of interstate commerce"<sup>53</sup> in connection with the investment advisory business. In *S.E.C. v. Wilson*,<sup>54</sup> the Commission obtained injunctive relief to restrain violation of this provision of the Act. This is the only court<sup>55</sup> case dealing with the Investment Advisers Act at this writing. This prohibition does not apply to three types of advisers who are deemed to be beyond the purpose of the Act: first, any adviser all of whose clients reside in the state in which the advisory business is conducted;<sup>56</sup> second, any adviser who furnishes advice only to investment companies and insurance companies;<sup>57</sup> third, any adviser who during the preceding year has had less than fifteen clients and who does not generally hold himself out to the public as an investment adviser.<sup>58</sup>

Registration is achieved by filing an application with the Commission

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50. 2 P-H SECURITIES REG. SERV. 27, 612.1 (1946). (The letter of the General Council is dated Oct. 28, 1940.)

51. *Ibid.*

52. *Ibid.*

53. Section 203(a).

54. U.S. Dist. Ct., E.D. Ill., Feb. 3, 1945 (unreported). 11 SEC ANN. REP. (1945) 79.

55. All other cases dealing with the Act are decisions of the Commission.

56. Section 203(b)(1).

57. Section 203(b)(2).

58. Section 203(b)(3).

which will, in general, become effective within thirty days after receipt.<sup>59</sup> The application must contain such of the information listed in the Act, in such manner and detail, as the Commission by rules shall prescribe "as necessary or appropriate in the public interest or for the protection of investors."<sup>60</sup> In addition to routine business information<sup>61</sup> and the furnishing of any felony record<sup>62</sup> in connection with securities in the past decade or injunction record<sup>63</sup> pertaining to the same subject, the applicant may be required by the Commission to furnish information relative to his education and present business affiliations, as well as those for the past ten years of partners, officers, and directors and those performing similar functions.<sup>64</sup> Concerning the manner in which the business is conducted, the applicant will be required to specify his manner of rendering advice,<sup>65</sup> the extent of his authority over his clients' funds and accounts,<sup>66</sup> and the method of ascertainment of his compensation.<sup>67</sup>

The Commission is empowered after hearing to deny, revoke, or suspend any registration when it finds that such action is in the public interest<sup>68</sup> and that the applicant or adviser falls under one of the three following classifications: first, that he has within the past decade been convicted of a crime in connection with a securities or financial transaction;<sup>69</sup> second, that he is enjoined by court order from acting in a financial or investment capacity or from engaging in any securities or financial transaction;<sup>70</sup> third, that he has wilfully made material misrepresentations of fact or omitted to state material facts in his application.<sup>71</sup> It is not enough that the Commission finds that it is in the public interest that registration be denied, revoked or suspended or that one of the other three requirements exists alone. In a significant situation, *In the Matter of Myer*,<sup>72</sup> the applicant had been convicted of a larceny arising out of a securities transaction in 1932 but due to extenuating circumstances had been placed on probation. In 1937 he was enjoined from engaging in business as a broker or dealer while he was insolvent because of the dangers involved when the public carries on transactions with an insolvent broker. The injunction did not necessarily reflect on his character. The Commission

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59. Section 203(c)(2).

60. Section 203(c).

61. Section 203(c)(1)(A).

62. Section 203(c)(1)(F).

63. *Ibid.*

64. Section 203(c)(1)(B).

65. Section 203(c)(1)(C).

66. Section 203(c)(1)(D).

67. Section 203(c)(1)(E).

68. Section 203(d).

69. Section 203(d)(1).

70. Section 203(d)(2).

71. Section 203(d)(3).

72. 8 S.E.C. 632 (1941).



held that considering all these circumstances, it was not in the public interest to deny registration as an adviser.<sup>73</sup> In another situation, *In the Matter of Dyer*,<sup>74</sup> the respondent admitted that he was permanently enjoined from pursuing certain conduct in connection with the purchase and sale of securities. He further admitted that his practices included the converting to his own use of funds sent to him by his clients for the purchase of securities for them and the misrepresenting of the facts of particular transactions to his clients as well as misrepresenting the general nature of his advisory service. The Commission held that revocation of his registration was in the public interest. In the case *In the Matter of Crowder*,<sup>75</sup> the application for registration stated and the facts confirmed that the applicant had been enjoined from engaging in various acts in connection with the purchase and sale of securities. The decree followed upon an investigation by the Attorney General of New York which disclosed that applicant's customers were elderly people of modest means who relied entirely on applicant's knowledge of securities and that transactions which he effected for them were substantially out of line "with the prevailing price of the security being sold and at prices which represented a very high percentage of profit for Crowder."<sup>76</sup> The Commission held that in view of the character of the transactions which resulted in the injunction, it was in the public interest to deny registration.

It is submitted that the chief deficiency of the registration provisions is that there is no prescribed minimum of business competence for the applicant. Section 203(c)(1)(B) requires a statement of the educational background of the applicant but the Commission is not entitled to give this factor any weight in connection with the granting of the registration. It is difficult to see how the Act can achieve its objective of investor protection so long as it is silent on the vital subject of qualifications.

The proposed bill<sup>77</sup> constitutes a comprehensive effort to remedy the more serious weaknesses of the Act. It is broader in its scope than the Lea Bill<sup>78</sup> which the Commission has recommended that Congress enact.<sup>79</sup> Sec-

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73. "This conclusion is in large part based on the fact that Meyer does not propose to accept custody of clients' securities or to accept discretionary powers over clients' funds but will confine his services to the rendering of advice on investments." *Id.* at 634.

74. 10 S.E.C. 1235 (1942).

75. 8 S.E.C. 947 (1941).

76. *Id.* at 948.

77. The proposed bill is printed at the end of this Comment. It was drafted by Mr. Bruce C. Bennett, a student in the Vanderbilt Law School course in Corporate Finance, under the supervision of Professor Hugh L. Sowards. The proposed bill is reproduced here through the courtesy of Mr. Bennett.

78. H.R. 3691. The Lea Bill was drafted by Professor Hugh L. Sowards, then a student in the Yale Law School, and introduced in the House of Representatives by Mr. Lea on July 5, 1945.

79. SEC, REPORT ON EMBEZZLEMENT OF CLIENTS' SECURITIES AND FUNDS BY TWO INVESTMENT ADVISERS AND RECOMMENDATIONS FOR AMENDING THE INVESTMENT ADVISERS ACT OF 1940 (1945).

tion 203(d) of the proposed bill provides for a written examination of all applicants as a condition precedent to registration. The requirement of an examination would, if it is submitted, be very effective in preventing wholly unqualified persons from continuing to do serious harm to the investing public.

A detailed comparison of Section 203 of the proposed bill with the same Section of the Act would seem to indicate the desirability of amending the Act along the lines recommended in the bill. Section 203(b)(1) of this bill exempts any present members or employees of any registered stock exchange house "who have been engaged principally in investment advisers business for the ten years prior to the enactment of this amended section." This exception is made because the excepted persons are strictly regulated by the Securities Act of 1933 and the Securities Exchange Act of 1934. Of course, if such a person has terminated his status as member or employee of such a stock exchange house, he becomes a person regulated by the bill. Section 203(b)(2) of the proposed bill is identical with Section 203(b)(1) of the original Act. Section 203(b)(3) is amended by adding eleemosynary corporations to the enumeration of investment advisory services which may be performed by an adviser who is not subject to the Act. It is believed by this writer that the exception is justified as being specialized advice analogous to the exceptions made of investment companies and insurance companies in the present Act. Section 203(b)(4) reduces the number of clients which an excepted adviser may have had in the preceding year from fifteen to ten. The purpose of this reduction in the number of clients an adviser may have before he is subjected to control is to reduce the number of border line advisers who are operating just beyond the reach of the Act.

Section 203(c) of the proposed bill makes the filing of an application with the Commission a condition precedent to registration. The application must contain information prescribed by the Commission "as necessary or appropriate in the public interest or for the protection of investors"<sup>80</sup> plus all information which the Act makes optional with the Commission. The former category is a new provision and its breadth is believed to be justified by the Commission's need for complete information in order to achieve effectively investor protection.

Section 203(d) contains one of the most important provisions of the proposed bill, the provision of a written examination of all applicants as a condition precedent to registration under the Act. The Board of Examiners is to be composed of three persons employed by the Commission for at least three years prior to the examination, and they are appointed by the Chairman of the Commission.<sup>81</sup> The small number of examiners is for the purpose

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80. Proposed bill, Section 203(c).

81. Proposed bill, Section 203(d)(1).

of securing definite responsibility for results. The manner of appointment is adopted so that the Chairman of the Commission will be enabled to effectuate his views as to the degree of business competency which should currently be required of advisers within the rather broad scope of the mandate that "the examination shall be such that will reflect the applicant's general knowledge of securities and his ability to advise investor clients."<sup>82</sup>

Section 203(d)(2) of this bill provides very stringent precautions to insure the impartial grading of each examination paper. The essence of the grading procedure is the use of numbers rather than names on the examination papers so that applicants who fail the examination will be less likely to take up government time with groundless claims of discrimination and unfair treatment. Similarly, the prohibition against any applicant taking the examination more than three times is directed at the would-be perennial candidate who lacks the desire or the ability to prepare himself adequately for the examination.<sup>83</sup>

Section 203(e) provides for the issuance of the registration certificate to successful applicants "no other factor as evidenced by the applicant's original application dictating to the contrary."<sup>84</sup> The purpose of this provision is to erect an additional barrier against the questionable or borderline applicant who has been smart enough to avoid the stigma of any court record and who consequently cannot be rejected on such grounds. Care is taken to avoid the certificate being used as a recommendation of the individual adviser's *abilities* by a plain statement on its face that the certificate is not such a recommendation by the Commission or the United States Government.<sup>85</sup> Provision is made for the certificate to be renewable annually without examination under rules which the Commission "shall reasonably find to be necessary and in the public interest."<sup>86</sup>

Revocation procedure is provided for in Section 203(f) of the proposed bill. The most significant change from the original Act is the addition of a summary mode of temporary revocation by the Chairman of the Commission "for good cause shown when he deems such action necessary to protect investors."<sup>87</sup> Provision is made for permanent revocation of an adviser's registration certificate only after a full and fair hearing before a board composed of personnel of the Commission.<sup>88</sup> This hearing is to be held at the Commission's regional office nearest to the residence or principal place of busi-

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82. *Ibid.*

83. Proposed bill, Section 203(d)(3).

84. Proposed bill, Section 203(e).

85. *Ibid.*

86. *Ibid.*

87. Proposed bill, Section 203(f).

88. *Ibid.*

ness of the registrant in order to preclude the possibility of hardship which might be involved in a trip to the headquarters of the Commission.<sup>89</sup>

These changes recommended in the proposed bill would eliminate some of the more serious deficiencies of the present Act. The examination should effectively bar the charlatans and the incompetents from the investment advisory field; and it is believed by this writer that the very existence of the power of summary revocation will furnish a strong incentive for registrants to avoid business conduct which is at best questionable.

Section 204 of the Act, in substance, requires that each registrant keep his file up to date by submitting to the Commission such annual and special reports as it may prescribe by rules and regulations. The proposed amendment to this section in the Lea Bill has been incorporated into the proposed bill<sup>90</sup> in toto, so reference will be made only to the changes in Section 204 of the Lea Bill. The purpose of the proposed change is to enable the Commission to keep a more adequate and complete system of records which would cover substantially the entire field of the advisory business. This aim is achieved by requiring all advisers, including those exempt and unregistered, who use the mails or any instrumentality of interstate commerce to maintain such records and to make such reports as the Commission "may prescribe as necessary or appropriate in the public interest or for the protection of investors."<sup>91</sup> It is further provided that such records are subject to examination at the discretion of the Commission.<sup>92</sup> It is obvious that this would provide a highly effective means by which the Commission could investigate to determine whether the Act was being violated. From the remedial standpoint this is far more efficacious than, in effect, requiring that the Commission do nothing until an investor is *actually hurt*.

Section 205 of the Act prohibits registered advisers from using the mails or any means of interstate commerce to in any way effectuate an "investment advisory contract"<sup>93</sup> which provides for compensation to the adviser on the basis of capital gains or appreciation, or which fails to provide that the contract shall be non-assignable without the consent of the client, or which fails to provide, if the investment adviser is a partnership, for notice of change in the firm to the client within a reasonable time. The change recommended in the Lea Bill<sup>94</sup> and adopted in full in the proposed bill<sup>95</sup> adds the requirement that all investment advisory contracts be in writing. The written contract will result in more careful consideration of terms and more considera-

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89. *Ibid.*

90. Proposed bill, Section 204.

91. Lea Bill, Section 204.

92. *Ibid.*

93. Section 205.

94. Lea Bill, Section 205.

95. Proposed bill, Section 205.

tion for the interests of the investor than would be usual in most parol contracts. The evidentiary value of the written contract in the event of litigation would be very great.

Section 206 of the Act prohibits any registered adviser from using any device or transaction to defraud a client but fails to prescribe a standard or to state what the prohibition specifically covers. An adviser is also prohibited from buying securities from, or selling securities to, any client, either as principal or as agent for another person, without notifying the client in writing as to the capacity in which he is acting and obtaining the client's consent thereto.<sup>96</sup> An opinion of the Director of the Trading and Exchange Division has construed this provision as requiring that a writing is necessary before the completion of each separate transaction.<sup>97</sup> The same opinion states that the minimum disclosure to the client should include the capacity in which the adviser wishes to act, the cost to the adviser of the security concerned if he wishes to sell to the client, the price at which he is reasonably certain he will resell the security if he proposes to buy from his client, and the best price elsewhere at which the transaction could be effected for the client if the client could obtain a more advantageous price elsewhere.<sup>98</sup> In short, the disclosure must be in all respects a complete one and fully consistent with the adviser's position as a fiduciary.

The Lea Bill<sup>99</sup> proposes to amend Section 206 by striking out the words which limit its application to registered investment advisers. The proposed bill<sup>100</sup> also adopts this mode of extending the prohibited transactions to all investment advisers. The significant contribution of the proposed bill here is to provide a *standard* by branding as a violation of the Act and a fraud on the investor those modes of rendering advice which "reflect negligence, disregard, and unwisdom to the ordinary prudent and reasonable investment adviser."<sup>101</sup> This provision effectively serves to eliminate the more obvious types of charlatans such as those who use astrology or their dreams as the basis for their "advice."<sup>102</sup> It would also very probably eliminate the "adviser" who bases his advice on "hunches," "intuition," or "tips."<sup>103</sup> The standard is not immutable but is subject to change with variation in the ethical standards of the advisory business. It is submitted that its adoption would provide an incentive to the reputable firms in the business to raise their standards even further.

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96. Section 206(3).

97. Investment Advisers Act of 1940 Release No. 40, Feb. 5, 1945.

98. *Ibid.*

99. Lea Bill, Section 206.

100. Proposed bill, Section 206.

101. Proposed bill, Section 206(1).

102. See note 28 *supra*.

103. See Wilson, *Paper Prophet*, Saturday Evening Post, July 27, 1940, p. 21.

Section 207 of the Act is left unamended by both of the proposed bills. It makes unlawful material misstatements or omissions to make material statements in any registration application or report filed under Sections 203 or 204.<sup>104</sup>

Section 208 prohibits a registered adviser from representing that he is recommended or approved by the Federal Government or an officer or agency thereof,<sup>105</sup> but this prohibition does not extend to prohibiting a person from stating that he is registered as an adviser under the Act if such statement is true.<sup>106</sup> A registered adviser is not allowed to use the title of "investment counsel" unless he is "primarily engaged in the business of rendering investment supervisory services" or unless his latest amended registration application states that he is primarily engaged in the investment supervisory business or is about to be so engaged.<sup>107</sup> This provision has led to difficulties in connection with the laws of certain states which require persons engaged in the business of giving financial advice to register and act as "investment counsel" without regard to the specific type of service which they render to clients. An opinion of the Commission's general counsel has resolved the problem by stating that it is merely a matter of good faith in honestly representing oneself to the public.<sup>108</sup> One who is an "investment counsel" only under state law and who points out that his status exists only under state law will run no risk of violating this provision of the Investment Advisers Act.<sup>109</sup>

The Lea Bill<sup>110</sup> and the proposed one<sup>111</sup> would amend this section<sup>112</sup> of the Act by making it unlawful for any person registered under Section 203 to have custody of securities or funds of his client unless his application for registration as amended discloses that he does or may have such custody. This provision is aimed at furnishing more adequate protection to clients who entrust their securities or funds to an adviser. It is believed that a reputable adviser who takes custody of securities and funds as a regular incident of his business would have no objection to reporting such practice. This proposal would also result in the Commission being able to check on violations

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104. The application of Section 207 was illustrated in a recent case, *In the Matter of Investment Registry of America, Inc.*, Investment Advisers Act of 1940 Release No. 42, Jan. 11, 1946, wherein the respondent's application for registration as an investment adviser stated, in part, that its contracts provided for a fee of not more than five per cent for the selection of securities. Respondent, in fact, charged considerably more by taking concealed profits. The Commission revoked respondent's registration and held that it had wilfully violated Section 207 by not amending its application.

105. Section 208(a).

106. Section 208(b).

107. Section 208(c).

108. Investment Advisers Act of 1940 Release No. 8, Dec. 12, 1940.

109. *Ibid.*

110. Lea Bill, Section 208(d).

111. Proposed bill, Section 208(d).

112. Section 208.

of Section 206(3) which requires disclosure as to the capacity in which the adviser is acting when he deals in securities with his client.

Section 209 of the Act deals with enforcement and provides that whenever it appears to the Commission that the Act has been or is about to be violated, the Commission may institute a formal investigation.<sup>113</sup> The Commission has pointed out that there is at present no provision for making inspections of the accounts and records of registered investment advisers analogous to that conferred upon the Commission by Section 17(a) of the Securities Exchange Act of 1934.<sup>114</sup> Section 204 of the proposed bill adequately eliminates this deficiency for reasons stated above. Section 209(e) provides that when the Commission shows that a person is about to engage or has engaged in any practices illegal under this Act, a permanent or temporary injunction shall be issued by the appropriate federal court. Until the present time the Commission has only once been able to invoke the aid of this provision.<sup>115</sup>

Section 210 of the Act attempts to use publicity as a sanction. Information in any registration statement shall be made available to the public unless the Commission by rules or by order upon application decides that such disclosure "is neither necessary nor appropriate in the public interest or for the protection of investors."<sup>116</sup> The Commission may not disclose the existence or the results of an investigation except in the event of a request from either House of Congress<sup>117</sup> or in the event of public hearings prescribed by Section 212 of the Act.<sup>118</sup> Section 210 further provides that an adviser engaged in the investment supervisory business shall not be required to disclose the identity or business affairs of any client except insofar as such disclosure may be appropriate in a particular proceeding or investigation which has as its aim the enforcement of this Title of this Act.<sup>119</sup> Both the Lea Bill<sup>120</sup> and the proposed one<sup>121</sup> would broaden the excepted instances where disclosure is allowed by including "examination" along with proceedings and investigation. It is submitted that it is appropriate to place the proposed examination on the same footing as other proceedings under the Act for publicity purposes.

The remaining sections of the Act give the Commission the rule making

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113. Section 209(a).

114. 8 SEC ANN. REP. 35, 36 (1942).

115. S.E.C. v. Wilson, U.S. Dist. Ct., E.D. Ill., Feb. 3, 1945 (unreported). 11 SEC ANN. REP. 79 (1945).

116. Section 210(a).

117. Section 210(b)(2).

118. Section 210(b)(1).

119. Section 210(c).

120. Lea Bill, Section 210(c).

121. Proposed bill, Section 210(c).

power<sup>122</sup> and provide for appeal from the Commission's orders to one of the circuit courts of appeal or to the Court of Appeals for the District of Columbia,<sup>123</sup> and provide that the federal district courts shall have exclusive jurisdiction under the Act except in equity suits where they shall have concurrent jurisdiction.<sup>124</sup> The Act also provides for submission of annual reports by the Commission to Congress,<sup>125</sup> and states that purported waiver of the conditions of the Act is void as are contracts in violation of the Act.<sup>126</sup> The usual separability provision is included,<sup>127</sup> and the penalty for wilful violation of the Act is a fine of not more than \$10,000, imprisonment for not more than two years, or both.<sup>128</sup>

#### ILLUSTRATIONS OF INADEQUACY OF THE ACT

The Commission has prepared and sent to Congress, along with recommendations for amending the Act, two detailed case histories which are illustrative of the inadequacies of the present Act.<sup>129</sup> To use the words of the Commission in its letter of transmittal to Congress:

"Our experience in the administration of this Act over the past four years impels the conclusion that it cannot be effectively enforced in its present form. The cases of Robert J. Boltz and Albert K. Atkinson, outlined in the report, illustrate the type of fraudulent activities in which certain unscrupulous investment advisers are able to engage at present without affording this Commission the slightest overt evidence of their occurrence. We are unable to detect or prevent such activities principally because we lack the power to inspect the books and records of investment advisers—a power which we have in the case of brokers and dealers under the Securities Exchange Act of 1934."<sup>130</sup>

Albert E. Atkinson was registered with the Commission both as an adviser under the Act and as a broker-dealer under the Securities Exchange Act of 1934. A member of the Commission's staff sought permission several times to make an inspection of Atkinson's books, but was never successful. Finally a personal conference was arranged with Atkinson who stated that he only had five or six clients, each of whom paid him an annual fee of \$5,000. He said that he maintained his broker-dealer registration only so that it would be readily available when and if he should desire to engage in the securities

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122. Section 211.

123. Section 213.

124. Section 214.

125. Section 216.

126. Section 215.

127. Section 219.

128. Section 217.

129. SEC, REPORT ON EMBEZZLEMENT OF CLIENTS' SECURITIES AND FUNDS BY TWO INVESTMENT ADVISERS AND RECOMMENDATIONS FOR AMENDING THE INVESTMENT ADVISERS ACT OF 1940 (1945).

130. *Ibid.*



business. He further stated that his only dealing with his customers was the selling of investment advice. As the Act gives the Commission no powers of inspection, the matter was deemed closed at this stage. At a later time information was obtained indicating that Atkinson's business was far more extensive than he had indicated. Almost a year after the first attempt to see his books, a formal investigation was instituted by the Commission. Atkinson's customers were reluctant to testify, for they appeared to trust him completely. "Many of them believed him to be a market wizard."<sup>131</sup> The break in the case came about as a result of one of the customers being advised by his attorney, when the latter learned of the investigation, to withdraw at least a portion of his equities from Atkinson immediately. This customer and another one went to see Atkinson and one received checks aggregating \$150,000, and the other received a check for \$50,000. Atkinson then deposited worthless checks in various banks in an attempt to create the impression that he had sufficient funds to meet the checks given to the customers. This ruse worked with the one who had the \$50,000 check, but when the other attempted to collect upon his checks, the banks concerned discovered that Atkinson's checks were worthless. The customers then arranged another conference with Atkinson to take place on September 2, 1942, but he committed suicide prior to that date. The Commission ordered the investigation to continue but no books or records were ever found. Checks and check stubs along with all other available means of information revealed that Atkinson had had a total of about 150 clients during his ten years of operations. These clients had placed approximately \$1,700,000 with him and had finally received back \$600,000 less than that amount. His assets located up to the date of the Commission's report amounted to about \$25,000. His compensation in almost every instance was based upon a share of the client's capital appreciation, which was directly contrary to statements made by him to a member of the Commission's staff. The Commission thinks, very justifiably, that had Atkinson been required to keep books and records as an adviser and to have written advisory contracts, and that had his business been subject to inspection by the Commission, his activities would have come to light much sooner.<sup>132</sup>

The case of Robert J. Boltz broke shortly before the Investment Advisers Act became effective. Boltz had operated an advisory business in Philadelphia for over thirteen years but had registered as a broker-dealer with neither the federal nor the state securities commissions. In October, 1940, when the state commission requested permission to examine his books and records, he asked for a day's time to consider it and immediately disappeared. Thereafter the state and federal commissions worked together on the ensuing in-

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131. *Id.* at 3.

132. *Id.* at 3, 4.

vestigation. On December 10, 1940, Boltz was indicted under the fraud sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 and the Mail Fraud Statute. Then on December 30, 1940, the state indicted him for embezzlement and fraudulent conversion. In February, 1941, Boltz was apprehended in New York where he was living under an assumed name. He pleaded guilty to both federal and state charges and was sentenced to twenty years imprisonment on the federal charges to run concurrently with the state sentence of twenty to forty years. In August, 1942, the receiver announced that the one hundred and eighty clients of Boltz who had established claims would shortly receive a two per cent initial payment on the \$1,500,000 in cash and securities placed with Boltz for investment. The receiver also indicated that not more than three and one-half per cent would be returned. Boltz was an attorney, and gradually had converted his law practice into an unethical advisory business by giving financial advice to clients until he had abandoned the practice of law and was acting solely as an "investment adviser." The Boltz method of conducting the advisory business was based upon a signed contract which gave him full discretionary power over all funds and securities entrusted to him. He almost immediately converted the securities he received into cash, which was, of course, used for his own benefit. By means of fictitious entries of transactions the client's account was made to appear as if the client had made a substantial profit over the amount which he had originally entrusted to Boltz.<sup>133</sup>

Both Boltz and Atkinson in their personal appearance and business demeanors gave a convincing appearance of financial responsibility. The clients of both these men had deep seated trust in them. Even after Boltz's unexplained disappearance from the community, many of his friends refused to believe that he could be implicated in any questionable activities. Even though the *Boltz* case broke prior to the effective date of the Investment Advisers Act, it illustrates well the practices which could usually be prevented by granting to the Commission the power to require maintenance of business records by investment advisers coupled with the power to inspect them. Under the circumstances shown in these cases there was no outward indication of wrongdoing. In the absence of such a manifestation, the Commission cannot take precautions to protect investors under the present Act. The Commission is keenly aware of the deficiencies of the present Act, as is indicated by its recommendations made to Congress on January 31, 1945, in which it asked the enactment of the entire Lea Bill as the basic minimum of change which would permit the Commission to carry out effectively the intention of Congress to protect investors.<sup>134</sup> The Commission regards the Lea Bill as recom-

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133. *Id.* at 4, 5.

134. *Id.* at 8.

amending "no more than the minimum of proposals it considers essential to protect the securities and funds which customers may place in the custody of their investment advisers."<sup>135</sup>

#### CONCLUSIONS

The analysis of the present Act reveals five main weaknesses. First, it does not require the attainment of any degree of knowledge of securities supervision for registration as an investment adviser. Second, it does not require a sufficiently adequate and complete set of records or provide for power of examination thereof by the Commission. Third, it allows a verbal investment advisory contract which can easily be subject to misconstruction or to fraud. Fourth, it fails to provide a standard of what constitutes fraud on a client, and the fraud section is inapplicable to unregistered advisers. Fifth, it does not require that the registration statement disclose custody of clients' securities and funds as a condition precedent to the legality of such custody.

The proposed bill goes beyond the Lea Bill, which the Commission recommended as a minimum improvement, in suggesting corrections for these deficiencies. It provides for an examination to determine that the applicant has the requisite knowledge of securities and the necessary ability properly to advise investor clients. It requires all advisers within the scope of federal constitutional power, including those who are unregistered, to maintain records which the Commission deems necessary and which are open to examination at the discretion of the Commission. It provides that advisers who use the mails or any instrumentality of interstate commerce use written investment advisory contracts. It prescribes a standard of fraud applicable to both registered and unregistered advisers which would outlaw many of the undesirable and unethical practices which flourish today. Finally, it makes unlawful the custody of the clients' securities and funds unless the adviser's registration discloses the existence of such practice.

There is no cause for complacency based on the view that other federal securities statutes have indirectly answered the problem of investor protection. Under the Securities Exchange Act of 1934 the Commission has been signally effective in preventing manipulative practices.<sup>136</sup> However, there is convincing recent evidence that market breaks can result in the absence of manipulation, as shown by the Commission's report on the market break of September 3, 1946.<sup>137</sup> When the present bull market comes to an end it will be too late to enact adequate investor protection.\* W. T. MALLISON, JR.

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135. *Ibid.*

136. See Comment, *Regulation of Stock Market Manipulation*, 56 YALE L. J. 509, 533 (1947).

137. SEC, A REPORT ON STOCK TRADING ON THE NEW YORK STOCK EXCHANGE ON SEPTEMBER 3, 1946 (1947).

\*See proposed bill on the succeeding page.

\_\_\_\_\_ Congress H. R. \_\_\_\_\_

## IN THE HOUSE OF REPRESENTATIVES

(Date)

### A BILL

#### To Amend the Investment Advisers Act of 1940

1 Be it enacted by the Senate and House of Representatives of the United  
2 States of America in Congress assembled, That section 203 of the Invest-  
3 ment Advisers Act of 1940 is amended to read as follows:

#### 4 "REGISTRATION OF INVESTMENT ADVISERS

5 "Sec. 203. (a) Except as provided in subsections (b), (c), (d), and (e),  
6 of this section, it shall be unlawful for any investment adviser, unless  
7 registered and holding a currently effective certificate as provided for in  
8 subsection (e) of this section, to make use of the mails or any means or  
9 any instrumentality of interstate commerce in connection with his or its  
10 business as an investment adviser.

- 11 (b) The provisions of subsection (a) shall not apply to
- 12 (1) any member or present employee of any registered stock  
13 exchange house, as listed in the Securities and Exchange  
14 Act of 1934, Sec. 6 (a), Registration of National Securities  
15 Exchanges, who has been engaged principally in investment  
16 adviser's business for the past ten years prior to the enact-  
17 ment of this amended Section;
  - 18 (2) any investment adviser all of whose clients are residents of  
19 the State within which such investment adviser maintains  
20 his or its principal office and place of business, and who does  
21 not furnish advice or issue analyses or reports with respect  
22 to securities listed or admitted to unlisted trading privileges  
23 on any national securities trading exchange;
  - 24 (3) any investment adviser whose only clients are investment  
25 companies, insurance companies, or eleemosynary corpora-  
26 tions; or
  - 27 (4) any investment adviser who during the course of the pre-  
28 ceding twelve months has had fewer than ten clients and  
29 who does not hold himself out generally to the public as an  
30 investment adviser."

31 Subsection (c), (d), (e), (f) and (g) of Section 203 are amended to  
read as follows:

32 “(c) All persons who presently contemplate compliance with the pro-  
33 visions of this Act may file an application for registration and  
34 submit to the examination as outlined in subsection (d). Such  
35 application shall contain the following information plus other  
36 information requested by the Commission as its rules and regu-  
37 lations may prescribe as necessary or appropriate in the public

1 interest or for the protection of investors:

2 (1) Information in respect to—

- 3 (A) the name and form of organization under which the  
4 investment adviser engages or intends to engage in  
5 business; the name of the State or other sovereign  
6 power under which such investment adviser is organ-  
7 ized; the location of his or its principal business office  
8 and branch offices, if any; the names and addresses  
9 of his or its partners, officers, directors, and persons  
10 performing similar functions or, if such an invest-  
11 ment adviser be an individual, of such individual; and  
12 the number of his or its employees;
- 13 (B) the education, the business affiliations for the past ten  
14 years, and the present business affiliations of such  
15 investment adviser and of his or its partners, officers,  
16 directors, and persons performing similar functions  
17 and of any controlling person thereof;
- 18 (C) the nature of the business of such investment adviser,  
19 including the manner of giving advice and rendering  
20 analyses or reports;
- 21 (D) the nature and scope of the authority of such invest-  
22 ment adviser with respect to clients' funds and ac-  
23 counts;
- 24 (E) the basis or bases upon which such investment adviser  
25 is compensated; and
- 26 (F) whether such an investment adviser or any partner,  
27 officer, director, person performing similar function  
28 or controlling person thereof (i) within ten years of  
29 the filing of such application has been convicted of  
30 any felony or misdemeanor involving the purchase or  
31 sale of any security or arising out of any conduct or  
32 practice of such investment adviser or affiliated per-  
33 son as an investment adviser, underwriter, broker,  
34 or dealer, or as an affiliated person or employee of any

investment company, bank, or insurance company, or  
(ii) at the time of the submission of the application,  
is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security, or

(2) a statement as to whether such investment adviser is engaged or is to engage primarily in the business of rendering investment supervisory services.

(d) Within ninety days after the enactment of this Section into law the Chairman of the Commission shall cause to be given a written examination to all applicants desiring to be registered as investment advisers. The Commission shall arrange to have the examinations given at the various regional offices of the Commission and in Washington, D. C. Examinations thereafter shall be given annually on the first Tuesday in the month of March of each succeeding year. Notification by the Commission of the time, date, place, and method of the annual examinations, and the first examination provided for above, shall be published in all newspapers of a general circulation with a paid subscription list of over 15,000 in the United States and Territories thereof at least thirty days prior to said examination.

(1) The Chairman of the Commission shall appoint a Board of Examiners, composed of three members of Commission personnel who shall have been employees of the Commission for at least three years prior to said examination. This Board of Examiners shall compile an examination to be given all applicants for registration, unless the provisions of subsection (b) of this Section are applicable. The examination shall be such that will reflect the applicant's general knowledge of securities and his ability to advise investor clients.

(2) The Chairman of the Commission, or his executive assistant after receiving the applications of those desiring to take the examination, shall have printed the examination sub-

30           mitted by the Board of Examiners, each copy thereof to  
31           have a number. A separate piece of paper, bearing only the  
32           applicant's name, shall then be attached to the copy of the  
33           examination, and a list of the names of the applicants com-  
34           piled with the corresponding number of the examination  
35           that applicant will take. Thereafter this list shall remain in  
36           the custody of the Chairman of the Commission. The exam-  
37           ination papers shall then be placed in the hands of Com-  
38           mission personnel designated to conduct the examination.  
39           When the applicant is handed his copy of the examination,  
40           he shall remove his name therefrom, and after examination  
41           the papers shall be forwarded to the Board of Examiners  
42           in Washington, D. C., for grading. After grading the ex-  
43           aminations, the Board of Examiners shall notify the Chair-  
44           man of the Commission of the grades of the applicants, as  
45           identified by their numbers, and shall list those who have

1           met the minimum standards set up by the Board of Ex-  
2           aminers.

3           (3) No applicant shall be eligible to take the examination more  
4           than three times.

5           (e) Immediately after the Chairman of the Commission receives the  
6           grades, and no other factor as evidenced by the applicant's orig-  
7           inal application dictating to the contrary, the Chairman shall  
8           cause to be issued to the successful applicant a certificate attest-  
9           ing to the fact that said applicant's qualifications have been  
10          passed on and are now on file in the office of the Commission,  
11          and that he has been licensed to practice as an investment adviser.  
12          The certificate issued by the Commission shall specifically state:  
13          'This certificate is not deemed to be a sponsorship, recommenda-  
14          tion, or approval of the above registrant's abilities as an invest-  
15          ment adviser by the Securities and Exchange Commission or the  
16          United States Government.' The certificate shall be renewable  
17          annually, without examination, upon application of the regis-  
18          trant under such rules and regulations as the Commission shall  
19          reasonably find to be necessary and in the public interest.

20          (f) The Chairman of the Commission is hereby granted power to  
21          issue temporary revocation orders revoking the certificate of any  
22          registrant for good cause shown when he deems such action neces-  
23          sary to protect investors. Within ten days after such revocation  
24          order the Commission shall set a date, not sooner than fifteen

25 nor later than thirty days, within which time a hearing shall be  
26 conducted in the regional Commission office nearest the principal  
27 place of business or residence of the registrant. At this stated  
28 time the registrant shall have an opportunity to be heard, rep-  
29 resented by counsel, and shall have access to such other equitable  
30 information in the hands of the Commission as the Chairman of  
31 the Commission deems proper. At the time the temporary revoca-  
32 tion order is issued the Commission shall prepare a complete  
33 statement and basis for the order, and a copy shall be attached  
34 to the revocation order sent to the registrant. The regional di-  
35 rector of the Securities and Exchange Commission shall appoint  
36 a board composed of three of the personnel of such Commission  
37 to hear the charges and make a recommendation to the Chairman  
38 of the Commission, and the Chairman shall then remove the  
39 revocation order or permanently revoke registrant's certificate.  
40 Any registrant who has had his certificate revoked shall not  
41 thereafter be permitted to apply for a certificate, or take any  
42 examination with a view to registration, until after the expira-  
43 tion of three years from the date of final determination by the  
44 Chairman of the Commission.

45 (g) Any successor to the business of an investment adviser regis-

1 tered and certified under this Section shall not succeed to the  
2 rights, powers, privileges, and immunities of said registrant.

3 (h) Any person registered under this Section may, upon such terms  
4 and conditions as the Commission finds necessary in the public  
5 interest or for the protection of investors, withdraw from regis-  
6 tration by filing a written notice of withdrawal with the Com-  
7 mission. If the Commission finds that any person registered under  
8 this Section, or who has pending an application for registration  
9 filed under this Section, is no longer in business or is not en-  
10 gaged in business as an investment adviser, the Commission  
11 shall by order cancel the registration of such person."

12 Section 204 of the Act is amended to read as follows:

13 "RECORDS AND REPORTS: EXAMINATION OF RECORDS

14 "Sec. 204. Every investment adviser who makes use of the mails or any  
15 means or instrumentality of interstate commerce in connection with his  
16 or its business<sup>2</sup> as an investment adviser shall make, keep, and preserve  
17 for such periods, such accounts, correspondence, memoranda, papers,  
18 books, and other records, and make such reports, as the Commission by



19 its rules and regulations may prescribe as necessary or appropriate in the  
20 public interest or for the protection of investors. Such accounts, corre-  
21 spondence, memoranda, papers, books, and other records shall be subject  
22 at any time or from time to time to such reasonable periodic, special, or  
23 other examinations by examiners or other representatives of the Com-  
24 mission as the Commission may deem necessary or appropriate in the  
25 public interest or for the protection of investors.”

26 Sec. 2. Section 205 of the Act is amended to read as follows:

27 “INVESTMENT ADVISORY CONTRACTS

28 “Sec. 205. No investment adviser registered under Section 203 shall  
29 make use of the mails or any means or instrumentality of interstate com-  
30 merce, directly or indirectly, to enter into, extend, or renew any investment  
31 advisory contract, or in any way to perform any investment advisory con-  
32 tract entered into, extended, or renewed on or after the effective date of  
33 this Title, if such contract—

34 (1) is not in writing;

35 (2) provides for compensation to the investment adviser on the basis  
36 of a share of capital gains upon or capital appreciation of the  
37 funds or any portion of the funds of the client;

38 (3) fails to provide, in substance, that no assignment of such con-  
39 tract shall be made by the investment adviser without the consent  
40 of the other party to the contract; or

41 (4) fails to provide, in substance, that the investment adviser, if a  
42 partnership, will notify the other party to the contract of any  
43 change in the membership of such partnership within a reason-  
able time after such change.

1 As used in this Section, ‘investment advisory contract’ means any contract  
2 or agreement whereby a person agrees to act as investment adviser or to  
3 manage any investment or trading account for a person other than an in-  
4 vestment company. Paragraph (2) of this Section shall not be construed  
5 to prohibit an investment advisory contract which provides for compensa-  
6 tion based upon the total value of a fund averaged over a definite period,  
7 or as of definite dates, or taken as of a definite date.”

8 Section 206 of the Act is amended to read as follows:

9 “PROHIBITED TRANSACTIONS BY INVESTMENT ADVISERS

10 “Sec. 206. It shall be unlawful for any investment adviser, by use of  
11 the mails or any means or instrumentality of interstate commerce, directly  
12 or indirectly—

13 (1) to employ any device, scheme, or artifice to defraud any client

14 or prospective client. 'Fraud', as defined in this Section, shall in-  
15 clude any artifice, scheme, or device used or employed by any per-  
16 son in giving advice relative to the purchase or sale of any secur-  
17 ities who is unexamined and unregistered as provided for in Sec-  
18 tion 203, as amended, of this Act. Any conjectural basis, derived  
19 from sources that reflect negligence, disregard, and unwisdom to  
20 the ordinary prudent and reasonable investment adviser, that are  
21 used for the foundation of advice from investment adviser to  
22 investor, is hereby declared to be a violation of the essence of  
23 this Act and a fraud on such investor.

24 (2) to engage in any transaction, practice, or course of business  
25 which operates as a fraud or deceit upon any client or prospec-  
26 tive client;

27 (3) acting as principal for his own account, knowingly to sell any  
28 security to or purchase any security from a client; or acting as  
29 broker for a person other than such client, knowingly to effect  
30 any sale or purchase of any security for the account of such client,  
31 without disclosing to such client in writing before the completion  
32 of such transaction the capacity in which he is acting and ob-  
33 taining the consent of the client to such transaction. The pro-  
34 hibitions of this paragraph (3) shall not apply to any trans-  
35 action with a customer of a broker or dealer if such broker or  
36 dealer is not acting as an investment adviser in relation to such  
37 transaction."

38 Section 208 of the Act is amended by inserting after the word "REP-  
39 RESENTATIONS" in the heading the words "AND ACTIVITIES";  
40 and by inserting after subsection (c) of such Section the following new  
41 subsection:

42 "(d) It shall be unlawful for any person not registered under Section  
43 203 of this Title, unless otherwise exempt from the provisions of  
44 this Act, to take or have custody of any securities or funds of  
any client."

1 Subsection (c) of Section 210 of the Act is amended to read as follows:

2 "(c) No provision of this Title shall be construed to require, or to  
3 authorize the Commission to require, any investment adviser  
4 engaged in rendering investment supervisory services to disclose  
5 the identity, investments, or affairs of any client of such invest-  
6 ment adviser, except insofar as such disclosure may be necessary  
7 or appropriate in a particular proceeding, examination, or in-  
8 vestigation having as its object the enforcement of a provision or  
9 provisions of this Title."