CAUTION - For Release 4:30 PM, Thursday, May 12, 1955

RESPONSIBILITIES OF INVESTMENT ADVISERS

Address of

J. SINCLAIR ARMSTRONG

Commissioner,

Securities and Exchange Commission

before the

INVESTMENT COUNSEL ASSOCIATION OF AMERICA

New York, N. Y.

May 12, 1955

It is a great pleasure for me to be here this afternoon to participate with you in the Forum and join you at the Annual Dinner of the Investment Counsel Association of America. I always enjoy coming back to New York, among other reasons because New York was once my own "home town". I spent the first 25 years of my life within a radius of a couple of miles of this building. In addition, it is a special privilege for me to be with you who know so much about how to feel the pulse and take the temperature - perhaps even take the blood count - of the American securities markets.

A few days ago I read the concise statement of functions and principles of the Investment Counsel Association of America. You call it your "Code of Ethics". It is encouraging to find a group of people engaged in giving investment advice to the public as aware of their status as fiduciaries and of their obligations and responsibilities as your Code of Ethics shows your members are.

I noticed that some of your principles take cognizance of specific provisions of the Federal Investment Advisers Act. For example, there is a statement that no assignment of a contract should be made without the consent of the client. There is a statement that a partnership should notify the client of any change in the members of the partnership. These two statements closely follow the provisions of Sections 205(2) and (3) of the Act. The principle that compensation should consist of direct charges for services rendered and should not be contingent upon profits recognizes and supplements the provisions of Section 205(1) of the Act.

Most encouraging is the emphasis placed in your statement of functions and principles on ability to render unbiased investment advice, confidential relationship, competence, and, above all, on integrity. These are all appealing to a person who has responsibility for administering the Federal securities laws.

Many people have some general information about the provisions of the Federal securities laws, but too few remember that these Acts which the Securities and Exchange Commission administers allocate responsibility to various groups. Responsibility is imposed by the Acts on issuers of securities and their officers, directors and controlling persons. Responsibility is imposed on underwriters of securities. Responsibility is placed on brokers and dealers in securities, on national securities exchange and associations, on investment advisers and others. Responsibility is placed on, and great advantages are given to, investors - the investing public - by these laws. Fulfillment of the aims of the Federal securities laws depends in great part upon the cooperative efforts of all persons who are expected, under the statutory scheme, to assume responsibility.

We at the Securities and Exchange Commission have many responsibilities under the Acts. We have various legal powers to help us meet these responsibilities. In addition, the Acts provide for sanctions

against persons who violate the laws or who violate the rules and regulations of the Commission adopted under the laws. A registered broker-dealer who knowingly makes misrepresentations of material facts to customers in connection with the purchase or sale of securities may forfeit his registration and thus be unable to conduct his business. Under certain circumstances he may even find that he is subjected to possible criminal penalties. Similarly, a registered investment adviser who engages in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client may subject himself to penalties and sanctions.

However, while these penalties and sanctions are necessary to make the Acts effective, it is not the penalties and sanctions standing alone which determine the value or the effectiveness of the law. The fact that a law has teeth in it does not necessarily mean that it will furnish economic nourishment to a community. The community can benefit from a law only if it works. It can work only if all the different groups who participate in activities under the law - that is government, industry, securities business and investing public - assume their specified roles and responsibilities under the law.

Under the Investment Advisers Act, particularly, this means that investment advisers must accept their responsibilities. If they hold themselves out as able to render investment advice they must be competent to give unbiased investment advice. They must maintain the organization and facilities needed to get and evaluate the facts on which unbiased investment advice can be based. If they are selling investment advisory services in the nature of bulletins, analyses, or reports they must be sure that the factual statements made and the advice given are clear and accurate so that the client understands not only what is being recommended but why. The basis of compensation of investment advisers should be fair and reasonable and should be related to the service rendered. Since an investment adviser is a fiduciary, he should avoid situations which create conflicts of interest.

I know from reading the statement of principles which I mentioned a moment ago that the members of your Association should not have any difficulty in assuming their responsibilities and meeting their obligations under the law.

As you know, the Investment Advisers Act provides that any investment adviser who has not been convicted of certain types of criminal acts, who is not subject to a court order enjoining him from engaging in certain activities, and who files an accurate and complete application is eligible to become registered as an investment adviser. While the Act requires the applicant to disclose certain information about his background, it does not require him to meet any particular standards of competency. While it prohibits fraudulent and deceptive practices, it does not require the applicant to follow any general code of ethics.

Laws which have to be administered by the Federal government must have definite standards, particularly where they contain such drastic and punitive provisions as make it possible for the administrative agency enforcing the law to put a person out of business. The standards to be applied in determining whether an applicant is eligible for a license or registration must be definite and certain, so that it can be clear to everyone what constitutes a disqualification. The laws must be such that they can be fairly and objectively applied, and also understood by those who are subject to them.

On the other hand, there are other factors that are extremely important in the practice of any profession, even though they may frequently be less definite and certain and more difficult to apply. I have in mind the concepts generally expressed in such words as "character", "ethics", "morality", integrity".

Generally speaking, the standards of ethics, morality and integrity which a man applies in his own business depend pretty much on his own conscience, his training and background, and the standards generally followed by other people engaged in a similar activity and in competition with him. In any business, and particularly in any profession, where the standards of ethics, morality and integrity are high, the public - that is the clients, the customers - understand and recognize the existence of these factors. This gives the public confidence in the people they deal with and who deal with them, and in the long run the persons practicing the particular profession, or engaging in the particular business, who adhere to high standards, gain the confidence of their clients and customers and reap the material rewards which come from this.

In the almost two years in which I have been a member of the Securities and Exchange Commission I have had an opportunity to realize more than ever before the important contribution which the securities industry and certain professional organizations can make to the accomplishment of the purposes and aims of the laws which the Commission administers in the public interest. As a practicing lawyer and an active participant in bar association activities, of course I had some realization of this before, but seeing it from the Government side gives me a better rounded, a more comprehensive, view. Any organized group with the same or similar business or professional interests can help to further the purposes and aims of such laws as the Federal securities Acts. I believe that if the cooperative efforts of such organized groups in the securities industry are sincere and continuous they can reduce, in part at least, the necessity for and the extent of government regulation.

Let me stress just for a moment two practical applications of the reduction of governmental regulation, one of which is working well, and one of which is having to be modified. When those of us whose

appointments derived from the new national administration joined the Commission in 1953, we found the Congress, the Commission and the public ready for a program of simplification and streamlining of the Acts and the Commission's rules and forms. Of course this was not to be in any way which would reduce investor protection. Industry groups and the Commission cooperated with the Congress in legislation, which passed unanimously and became law on October 10, 1954, eliminating certain complex and unnecessary provisions of the Acts and providing better means for disseminating information about new securities to be sold to the public. The cooperation of industry groups and their recognition of their responsibilities under the securities laws made possible these very long needed revisions of the Federal regulatory scheme.

Also the Commission has been hard at work for the past two years on a program of revision and clarification of its rules, regulations and forms, to keep pace with changing practices and new developments. The primary objective is to eliminate duplication and encourage conciseness without sacrifice of any safeguards necessary for the protection of investors. This program continues as fast as our staff, which has been reduced in number, can work on it. Industry members and groups, including your association, are to be commended for suggestions you have submitted. We of Government solicit your continued cooperation and assistance in the rule and form revision program. Your goal as investment advisers and ours as administrators of the securities Acts should be parallel - seeking presentation to the public of adequate information in form suitable to intelligent investment decisions whether to buy, sell or hold securities.

But one action the Commission took reducing Federal regulation is being modified. In part because of Commission staff reduction, in part because of its inherent infirmities, in 1953 we rescinded the requirement (known as Form 9-K) of the quarterly reports of gross sales of listed companies. Investment advisers and financial analysts groups have been hammering at us constantly ever since to reinstate the requirement. We have worked out with you, the accounting profession and industry generally what we think is a far preferable requirement for semi-annual reports both of sales and net operating results. But I ask you, has industry assumed its proper responsibility in this field? The New York Stock Exchange can be commended for its listing requirements under which a vast majority of its listed companies publish quarterly reports of sales or net profit or both. Why should the expensive and heavy hand of the Federal Government be needed to rope in the stragglers who do not make interim reports to the New York Stock Exchange or are not even asked to make interim reports by the other exchanges? It seems to me your profession could bring great influence to bear on non-reporting companies. Most progressive managements are sensitive to your views.

Let me also mention one area where at the present time neither Government regulation nor industry self-regulation are adequate. This is the advertising of securities. I am sure you are aware that some of

the advertising of securities which is presently being distributed by the securities industry is unsound, both from the standpoint of the industry and the American investor, for whose protection the Federal Securities and Exchange Commission was established by the Congress. Either the Commission or the industry, and perhaps both, are going to have to take prompt steps to correct this situation. Conceivably, effective Federal policing of the advertising of securities could be a cure. There is some official policing of advertising now in connection with new issues publicly offered and with respect to securities of investment companies, but by and large the Commission does not, as a matter of routine, supervise securities advertising generally. I ask you, should the Securities and Exchange Commission request the Congress for vastly increased appropriations so as to inspect all advertising for possible violations of the anti-fraud provisions of the statutes, so as to eliminate or control the allurements presently being held out to the public in the financial pages of newspapers, broadcast on the air waves, or sent through the mail? That would be one alternative.

Or should the self-regulating organizations of the securities business undertake to prescribe and enforce standards which take the flamboyance and the "come-on" techniques out of securities advertising? The National Association of Securities Dealers and at least one of the national securities exchanges, the New York Stock Exchange, have programs for self-policing of advertising by their members. It would be an act of wisdom in the public interest for them, the other exchanges, and other associations in the business to give additional emphasis to this problem. Your association, with its high standards of business conduct, might appropriately be a leader in this area. Failure by the securities industry itself to take effective steps in the face of widespread, justified criticism of undesirable practices indulged in by a minority of the business is an invitation to Government to use the Federal power to stamp out abuses of which the securities industry is aware but against which it has not yet moved with cohesiveness and determination. In the long run, the public interest in fair advertising of securities will have to be served, whether it be by the flexible and relatively inexpensive process of industry self-regulation or by the more rigid and expensive process of Federal regulation.

Americans have always been interested in freedom, and I am sure we shall become more and more interested in it. One important characteristic of a free society is its ability to establish its own standards in the public interest. This is true in economic as well as in political and social matters.

You know that many provisions of the Federal securities laws, particularly provisions of the Securities Act and the Securities Exchange Act, resulted primarily from the fact that during the roaring twenties many people, including those in the securities industry, had failed to recognize their responsibilities to the people they dealt with and to the public generally.

After the Exchange Act had been in effect for several years, organized groups in the industry came to realize it was in their own interest as well as the public interest to supplement Federal regulation by a kind of cooperative regulation of their own industry. The national securities exchanges reorganized their governing boards to give more recognition and representation to groups dealing directly with the public, and, in some cases, to the public directly. Many of you are familiar with the organization of the National Association of Securities Dealers, Inc., the "NASD", and the fine work it has done and is doing in maintaining ethical standards among brokers and dealers doing business in the over-the-counter markets. The NASD, as you know, was organized pursuant to amendments to the Exchange Act adopted several years after the original Act went into effect. To the extent that any such organization can maintain high standards acceptable to the majority of its members and enforceable against all, it not only inspires confidence among the customers of its members, but it thereby reduces the potential impact and scope of government regulation.

I wonder why an organization such as yours, with so admirable a statement of principles, is not more active in expanding its membership, and thus inducing eligible investment advisers to accept the responsibility of adhering to the high standards which you set for yourselves. I realize, of course, that not every investment adviser is eligible to join an association limited to "investment counsel"; that only those advisers primarily engaged in the business of giving continuous advice based on the individual needs of each client would meet that specification. However, more than 350 of the investment advisers who have filed Form ADV (the new simplified registration form which we adopted at the Commission in 1954) have indicated that they are primarily engaged in this business, and so qualify as investment counsel. I feel reasonably sure that many of them could be convinced that it is not only in the public interest but also in their own interest to belong to an organization such as yours. And it would seem to me that it would be in the interest of you who are already members to get these investment advisers into your organization.

You might also give serious thought to finding some way by which you can bring more vividly to the attention of the public, particularly to prospective investment-advisory clients, knowledge of the standards that should be applicable to persons who render investment advice. It would be helpful to persons who intend to employ, or are now employing investment advisers if they understood the qualifications which a competent investment adviser should have, the amount which competent investment advice should reasonably cost, and, particularly, the obligations which arise from the fiduciary relationship between the investment adviser and his client.

If the investing public could be made to realize that the standards of competence and integrity of investment advisers must be

high and the cost of the service must be reasonable for the client to get the full benefit of the service for which he is paying, each client and prospective client would come to expect and eventually require his investment adviser to meet these standards. This demand by the people who buy and pay for the service would then have to be met by investment advisers who expect to conduct their business successfully.

You investment counselors who can solve the many complicated problems involved in laying out investment programs for different individuals under many different circumstances should have very little difficulty in carrying forward an educational program to create a demand for the high standards which your association espouses, which I am sure the public would want, and which will be of benefit not only to investment advisers but to the public as a whole.