

A D D R E S S

By

R O B E R T I . M I L L O N Z I

Member

SECURITIES AND EXCHANGE COMMISSION

Before

INVESTMENT COUNSEL ASSOCIATION OF AMERICA

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Mr. Chairman, ladies and gentlemen:

When your Chairman invited me here this evening he wrote -- and I quote -- "we should be glad to have a brief talk from you." I assume, therefore, that if this talk is not brief he will not be glad. I shall try to make him happy.

There has always, it seems to me, been a real bond of understanding between your organization and the Commission. We have similar objectives and similar ideas about how and who should disseminate investment advice. This has led to a cooperation which I consider invaluable. That cooperation is perhaps best illustrated by our joint efforts in behalf of the bill which we now know as the Investment Adviser's Act. As you remember, it was passed by a unanimous Congress in a remarkable display of bipartisanship.

That was almost 12 years ago. Since then we have gotten to know a lot about your problems and we should now be able to determine how the statute is operating and what flaws or deficiencies exist. Insofar as the basic provisions governing registration are concerned I find myself well satisfied with the foresight of the draftsmen. They are simple, they have presented a minimum of problems of interpretation, and they seem to be almost self-operating. There have been only two actions by the Commission to prevent persons from doing business as an investment adviser without registration, and both resulted in consent injunctions.

The anti-fraud provisions, too, seem to be reasonably effective. Their enforcement is hampered somewhat by the failure of the Act to grant to the Commission authority to institute administrative proceedings to punish suspected violators, but where a Commission investigation discloses fraud the criminal and injunctive remedies have proved adequate.

The Act is chiefly defective, I believe, in not setting up standards for the qualifications of investment advisers. This is an area it does not attempt to cover. Frankly, I am not yet sure legislation should deal with the problem, for it is concerned more with the enforcement of ethical standards than the enforcement of legal standards, and I have always regarded ethics as a private rather than a public matter. It is only because of the important effect your profession has upon the national economy that the matter demands public attention.

If all investment advisers subscribed to the code of ethics of your association I would have little cause for concern. But, as you know, an investment adviser is often one in name only. Anyone may register as such with the Commission who can place an "X" where his signature belongs on the application. Having registered in this fashion, he can then print some stationery proudly describing himself as "Registered with the United States Securities and Exchange Commission."

From that time on, so long as he makes full disclosure of the basis for his predictions, he is free to advise any member of the public about the most complex financial problems. He may base his advice upon a complicated formula derived from either the Einstein theory of relativity or the toss of a coin.

One of the early applications for registration was received from a person who modestly described his education, background, and experience as including:

"Knowledge of oil investments and financing from a personal survey in the oil fields of Oklahoma, Texas, Montana and Canada; the study of all active and inactive gold mines in Canada; an exhaustive survey, studied very thoroughly, of investment trusts, railroad, public utility and industrial financing; several years study of stocks, bonds, brokerage business, stock market, price fluctuations, stock exchange practices, long and short sales, margin accounts, arbitrage, corporate organization, financing and interlocking directorates; and special attention given to the study of Municipal, State, and United States bonds."

In answer to the item calling for a description of his principal business and professional connections during the last 10 years it was stated:

"The Registrant has devoted his entire time to a comprehensive economic survey and study of the investment needs of the investing public."

After reading this I expected the application would be signed by that walking encyclopedia, Mr. Belvedere. But it was not. And upon further inquiry from the Commission staff who, I suspect, probably sought the information so that they might purchase the service, it developed that the applicant had been in prison for the past 10 years, serving a term for assault with intent to rob and murder. The registration was to assist him in obtaining a parole by showing that he had a gainful occupation. Of course, the application was ultimately withdrawn.

Obviously, persons who have been forced to spend a large part of their time in a penal institution, will, in most instances, have rather dubious qualifications to act as investment advisers. And the public can probably be trusted not to seek their advice on investment management. But there are many instances where the qualifications and ability of the investment adviser are even more obscure.

As of our last count, we had almost 1200 persons registered with us under the Act. Many of these are not persons who, by either training, education or experience are qualified to handle financial problems. Many of them act as investment advisers as a kind of paid hobby, with

some other occupation as their principal business. I estimate that almost fifty percent of our registrations fall within this category. Unfortunately, they usually indulge in their avocation at the expense of those people least able to afford to gamble with their money -- persons with but a few dollars to invest who are looking for bargains in investment advice. Registered with us, at one time or another, as investment advisers, we have had dentists, doctors, booking agents, dress designers, engineers, real estate salesmen, physicists, hotel managers, government clerks, and astrologers. Many of these, in their own field, are expert. But when they attempt to apply their own specialized knowledge to the securities business they often wind up with theories of market forecasting that would be ludicrous if their effect were not so serious.

Astrologers, convinced that the market movements follow the stars, base their predictions upon the planetary orbits. A physicist registered with us has worked out a complicated system of terrestrial magnetism to explain market movements. Even sun spots have been seriously credited with exerting the controlling influence upon market movements. And one person attempted to combine all knowledge into an "Astro-Economic Interpretation" which he published.

The Commission can do little to prevent these abuses, although we are exploring the possibility of bringing injunctive actions against the most egregious examples on the ground that it is fraudulent to make such claims. The Investment Adviser's Act, basically, is a disclosure statute. So long as the adviser fully discloses his system of prognostication we find he is usually complying with the Act, and fraud cannot be proved.

You are all familiar, I am sure, with the investment adviser who based his market advice upon an analysis of the comic strips. Little Orphan Annie was considered a particularly astute market operator. But she was much too shrewd to permit the uninitiated to profit from her advice. Instead, she used a secret code. It worked something like this: If she found a penny, Anaconda Copper was considered a good buy. If she fell over a chair, all holdings of American Seating should be liquidated. If she took a trip in an airplane, it was a signal that aircraft shares were going to lead a market rise. The writer of the market letters giving this advice did not, however, do any personal trading. He had been advised by an astrologer against speculation. -- But he earned as much as \$39,000 a year from the market letter he distributed.

I admit that these are somewhat extreme illustrations of the abuses that exist. And, in the case of the comic strip investment adviser, cooperation between the New York authorities and the Commission did result in putting him out of business. But the problem is nonetheless real.

Your profession is a constantly growing one. In 1940, there were 695 registered investment advisers. In 1945 there were 780. By 1948 the number had increased to over 1000. And as of now we have about 1200. The increase, I believe, reflects an increased need. More and more people are becoming interested in securities as a method of savings. War bonds served as a method of familiarizing the public with securities, and fear of inflationary trends have made them stock conscious. In addition, the growing complexity of industry, sudden expansions and contractions due to war scares, the mushrooming of new industries, and the high rates of obsolescence due to new scientific developments have emphasized the need for reliable investment advice. This has given your profession new and larger responsibilities.

Responsibilities, however, are always attended by obligations. One of your primary obligations, it seems to me, is to enforce a high level of ethical conduct upon the profession. As a lawyer, I am required to abide by canons of ethics established and enforced by national, state and local bar associations. Too great a deviation is grounds for disbarment. Doctors and dentists are similarly regulated. I regard it as anomalous that in a profession such as yours, affected as it is with the highest degree of public interest and impressed with great fiduciary responsibilities, no effective sanction against violation of ethical standards exists.

I recognize a code of professional practice which would keep out the unscrupulous and incompetent would be difficult to draft. It would probably be even more difficult to enforce. I think your association has made a start in the right direction in the code you have adopted and I compliment you for it. But I believe a code for the whole industry with sanctions against violation is necessary. How this is to be done, frankly, I am not sure. However, some attempt should be made to explore feasible solutions to this problem.

Possibly your association and the Investment Counselors' Association of Southern California might, with suitable legislative assistance, be the medium for the imposition of appropriate ethical standards upon the whole profession. Or, as an alternative, a system of examination, roughly analogous to C.P.A. examinations for accountants, might be the solution.

I feel strongly that something should be done to correct the situation. And while we at the Commission stand ready to lend whatever assistance may be required I believe the profession itself should undertake the corrective action.

I should like also to mention several other rather obvious omissions in the Act. As you know, the fraud provisions are applicable only to registered investment advisers. Others, who are not registered, are outside its scope. This just does not make sense, for certainly fraud

should be punished whether it is by a registered or an unregistered investment adviser.

Also, I feel that advisory contracts are sufficiently important so that they should all be in writing and available to inspection by the Commission. Only in this way can any degree of supervision over such contracts be exercised.

As you know, we have had these proposals for legislation under consideration since the war. No action has been taken upon them due to the pressure of other business. Bills introduced in Congress amending the Act in these respects have died in committee. But I hope that, in the not too distant future, we may again take up the consideration of how the administration of the Act may be improved. We hope that we will be able to count on your experience and advice to help us formulate our policies. For by our mutual assistance we can best serve the public investor and achieve the objectives we both seek.