THE SEC AND THE INVESTMENT COUNSELOR

Address by

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It is a very great pleasure for me to be here at the annual banquet of the Investment Counsel Association of America. I must say to you that I have enjoyed tremendously the prospects of visiting with you tonight and discussing with you some of the problems which confront the SEC as they relate to the business of the members of your association. I have been informed that your association has approximately 50 members and that, as of April 30, 1960, we had registered with the Securities and Exchange Commission some 1,832 investment advisers and 350 investment counsel. When I was invited to talk to you this evening, I was asked to talk about the Securities and Exchange Commission's legislative program insofar as it seeks to amend the Investment Advisers Act of 1940, and to explain the effects which these proposed amendments will have upon your industry. Before I get to that subject, I would like to go back and review some of the activities which have occurred in the capital markets in the not-too-distant past.

Let me take as a starting point the period just prior to the stock market crash in 1929. I think it would be of interest to you to reflect upon some of these facts. As of September 1, 1929, the value of all stocks on the New York Stock Exchange totaled some $89,000,000,000. By the middle of 1932, that value aggregated $15,000,000,000, or a loss of $74,000,000,000 on that exchange in the short space of some three years. Many of you will recall the complete demoralization which touched upon all segments of the investment banking business. During the 1930's, there were few people who would consider a security, whether of the equity or debt type, as the proper median of investment. People generally took their money and put it in savings institutions or sewed it into their own proverbial matresses. Into this debilitating picture came the Securities Act of 1933, with its basic concepts of disclosure and anti fraud provisions. Other acts and other factors, such as a World War II, produced an entirely different picture of dynamic growth. Essentially, investment confidence which had been almost completely destroyed following the 1929 stock market crash was restored gradually at first, and then more rapidly in the later years. People began to invest in securities at an almost fever-heat pace. The capital markets literally grew in leaps and bounds. By the middle of last year, the total value of stock on the New York Stock Exchange reached some $300,000,000,000. Stockholders in public corporations grew from 2,000,000 in 1936, to more than 12,500,000 today. The total shares listed on the New York Stock Exchange has grown from 2,000,000,000 in 1948, to over 6,000,000,000 shares today. This tremendous growth picture has been excitingly stimulating, not only to the casual observer, but

to the persons with specialized training or vocation. Unfortunately, the dynamic way in which it has occurred has inevitably attracted into all segments of the investment banking business, persons who are completely unscrupulous and who lack any desire, skill, ethical standards or knowledge of the high trust relationship involved in the handling of other peoples' money. As a result, there have been many instances of abuses and public investor losses in the investment field.

Some abuses have been found in the area of the Investment Advisers Act which have compelled us to re-examine the Act and the enforcement powers which the Commission has been given by the provisions of that Act. In my own mind, I am certain that the members of your association are fully conscious of the high degree of responsibility which each of you owe to your clients and to the public. We at the Commission are surely aware of the keen interest which each of you have in preventing all kinds of misrepresentation or fraud in the investment field and especially in the investment advisory activities.

The basic purpose of the Investment Advisers Act was to protect the public and investors against malpractices on the part of persons engaged for compensation in the business of advising others with respect to securities. The Act, in substance, states that it is unlawful for investment advisers registered under the Act to engage in fraudulent and deceptive practices. In addition, as you know, the Act also requires registered investment advisers to disclose the nature of their interests in transactions which they may effect for their clients, prohibits sharing arrangements with the clients and, for all practical purposes, prevents the assignment of any investment advisory contract without the consent of the interested client. The Securities and Exchange Commission, in its administration of the Investment Advisers Act, since its adoption in 1940, has found that the Act makes inadequate provisions in many respects and does not in fact afford the necessary protection to clients of investment advisers and other members of the investment business. We have seen many instances where persons who lack any conception of the high degree of trust relationship that must exist between the investment adviser and his client, have participated in fraudulent schemes or have employed ruses or artifices to accomplish deceptive and fraudulent results in cheating their clients. Many of these situations have unfortunately caused some repercussions which have to some extent reflected upon the professional standing of investment advisers and investment counsels and members of this association. I am sure that you will agree with me that one of the essential functions of the Securities and Exchange

Commission should be to eradicate this element from your profession. Unfortunately, the Act in many instances does not give us sufficient authority to accomplish this rather simple purpose. Let me illustrate. The Commission has no authority under the Act to inspect the books and records of investment advisers. The Commission cannot even require investment advisers to maintain books and records. It thus has no adequate means to determine whether investment advisers -- whoever they may be -- are engaging in fraudulent and deceptive practices in their business.

The present statute also provides for the registration of most investment advisers who use the mails or instrumentalities in interstate commerce in connection with their business. The Commission has a very limited right of denial of a registration, and in a real sense we are completely unable to prevent persons who, on any standard of fairness, would be considered undesirable. Let me illustrate. The provisions of the Act which prohibit fraudulent practices apply only to the investment advisers who happen to be registered. If an investment adviser, either by exemption or failure to register, undertakes the most vicious and fraudulent type of conduct with respect to the interest of his clients, he is not subject to the enforcement power of the Securities and Exchange Commission simply because he has not registered. This places an obvious premium upon evasion. In addition, the Act seems to be inadequate because it does not define, nor does it give the Commission any power to adopt rules and regulations defining, actions which are fraudulent, deceptive or manipulative, nor does the Act prescribe methods designed to prevent such practices.

Let me give another illustration of the weakness of the present Act. The staff of the Commission obtained information indicating that a particular individual was engaged in the securities business in reliance upon an exemption from registration because of the intrastate nature of his business. A Securities and Exchange Commission investigation had disclosed that in fact his business was of an interstate nature requiring his registration as a broker and dealer. The individual was invited to register as both a broker-dealer and as an investment adviser. His subsequent applications for registration plus further investigation indicated several serious violations of both the Securities Act of 1933 and the Securities Exchange Act of 1934. Among other things, his financial condition as reported in his filing as part of the broker-dealer application gave false information. The Securities and Exchange Commission by instituting appropriate proceedings was able to prevent this individual's registration

as a broker-dealer from becoming effective. However, since the violations of the Securities Act and the Securities Exchange Act did not constitute any bar to his registration as an investment adviser, that registration became effective. Prior to the hearing on the broker-dealer denial proceeding, the individual filed a petition in bankruptcy. The proceedings subsequently indicated that his customers and other broker-dealers will sustain substantial losses. Fortunately, in connection with a stipulation of the facts in the broker-dealer proceeding, we were able to obtain a withdrawal of the investment adviser's registration. However, this example clearly illustrates the anomaly of a situation which permits the Commission to deny registration to a broker-dealer applicant predicated on the willful violations of the Securities Act and the Securities Exchange Act, but gives no such authority to deny an application for registration as an investment adviser filed by the same person. It is my belief that you will all agree with me that if the Securities and Exchange Commission is to be effective in the regulation of investment advisers, some effective power must be provided to cope with the abuses which I have indicated exist. Of course, this power should not impose any back-breaking burdens upon the legitimate members of your industry or expose your clients to unnecessary public disclosure of their private affairs.

I have presented some of the weakness in the present Act. We believe that the amendments proposed by the Commission will materially assist it in enforcing the statute. These proposed amendments are designed to make the Commission's enforcement activities more effective by giving the Commission more authority and by providing additional remedies and eliminating or minimizing various problems which have come to light in the course of the Commission's enforcement of the Act. The more significant of these proposals would, in brief, (1) expand the basis for disqualification of an applicant for registration or a registrant because of misconduct; (2) revise the provisions relating to the postponement of effectiveness and the withdrawal of applications for registration; (3) authorize the Commission by rule to require the keeping of books and records and the filing of reports; (4) permit periodic examinations of a registrant's books and records; (5) empower the Commission by rule to define and prescribe means reasonably designed to prevent fraudulent practices; and (6) extend criminal liability to include a willful violation of a rule or an order of the Commission.

Let me go into these in some detail. The proposal to expand the basis for disqualification should be amended to include

any persons who have been convicted of embezzlement, fraudulent conversion or misappropriation of funds or securities, one who has violated the mail fraud statute or one who is subject to an injunction based upon such improper activities. In addition, a willful violation of the Securities Act, the Securities Exchange Act or the Investment Advisers Act should constitute a basis for a denial or revocation.

Under the present Act, an application for registration is not postponed by the commencement of a proceeding to determine whether an order of denial should be entered unless the Commission finds that such postponement is in the public interest. Under the terms of the Investment Advisers Act, a registration becomes effective 30 days after the application is filed. Since, under the present Act, an order postponing effectiveness can be entered only after notice and opportunity for hearing, it would be a practical impossibility to give adequate notice or comply with the terms of the Administrative Procedure Act within a 30-day period after the application is filed. Under our proposed amendments, the commencement of a proceeding denying registration would postpone effectiveness of an application for a period of 90 days or until final determination in the denial proceeding if that occurs sooner. The Commission could postpone effectiveness beyond the 90-day period only after a hearing on the question of further postponement.

The Act now contains no grant of power to inspect the books or records of investment advisers. In fact, there is no requirement that they maintain any books or records. The proposed amendments would require every investment adviser who employs the mails or instrumentalities of interstate commerce to keep and preserve certain books and records and make reports in accordance with rules and regulations prescribed by the Commission as necessary and appropriate in the interest of investors. It would also require that these books and records shall be subject at any time, or from time to time, to reasonable and periodic or special examination by the Securities and Exchange Commission.

The Commission had similar authority with respect to brokers or dealers under Section 17(a) of the Securities Exchange Act of 1934. This power of inspection would be limited, however, by Section 210(c) of the Act which provides that the Commission cannot require an investment adviser, engaged in rendering investment supervisory services, to disclose the identity, investments or affairs of any client except in a particular proceeding or

investigation. We at the Commission thoroughly understand your concern for confidential treatment of such matters. We recognize that many of the firms which give investment advice and are subject to the section have had relationships with their clients for some twenty or thirty years, during which time the firms have accumulated a host of documents and miscellaneous information bearing upon the client. We recognize that, in the absence of some overriding public interest, such information should not be susceptible to public scrutiny. Let me assure you that our functions in other areas of the six statutes which we administer, to say nothing of the participation of the Commission in Chapter X under the Bankruptcy Act, have always been predicated upon a private method of investigation. Our purpose is not to pry into matters of confidential or private natures. It is rather to act as an umpire to see that certain basic standards of doing business are complied with by persons who desire to become investment advisers. I think the reputation which the Commission has enjoyed since its inception some twenty-six years ago will establish to your satisfaction that we, as an agency, thoroughly understand your great concern in giving us investigatory or examination power, and will do all in our power to keep the disclosures made in the vast majority of cases confidential and undisclosed.

Section 206 of the Act now prohibits certain fraudulent and deceptive practices by registered investment advisers. This section is now applicable only to registered investment advisers. Fraud is no less vicious because it is perpetrated by an unregistered investment adviser. Just as the anti fraud provisions of the Securities and Exchange Act of 1934 are applicable to brokers and dealers irrespective of registration, so should the anti fraud provisions of this Act be applicable to all investment advisers. Our proposed amendments would rectify this situation.

Section 206 of the present Act contains general prohibitions against fraudulent activities. In view of the general language of this section and the absence of express rule-making power, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited, and the extent to which the Commission is limited in this area by common law conception of fraud and deceit. Our proposed amendment would empower the Commission by rules and regulations to design and prescribe means reasonably designed to prevent acts, practices and courses of conduct which are fraudulent, deceptive or manipulative. This is comparable to our power under the Securities

Exchange Act of 1934, which applies to brokers and dealers. If one reads this provision literally, there might be cause for some apprehension lest the Commission promulgate rules and regulations so meticulous in their requirements as to render business impossible to perform. Let me assure you that, in my opinion, this is neither the SEC intent nor its purpose. In fact, I think your basic beliefs and observations and ours are identical. The Administrative Procedure Act guarantees certain inalienable protections. In the past, the agency has thoroughly complied with the provisions of this Act and has always given interested persons an opportunity not only for comments but for hearings where advisable or necessary. I am certain that your industry and the Commission can promulgate rules and regulations which will be in the highest sense protective of the interests of your clients and the public, and yet impose certain standards which would increase the responsibility of members of your profession towards their clients and thus adding a measure of prestige to your entire industry. I can assure you that the rules and regulations which are ultimately adopted in this area will be designed to foster the principles of trust and confidence, and honest men will have little concern with the operational results of these rules. I should point out that a rule-making provision has far greater flexibility and is far less rigid than a statutory provision. In a very real sense, a rule can be cut or recut with relative simplicity of procedure in order to meet changing circumstances, whereas a statute, once adopted, remains fairly constant and might tend to thwart or frustrate the regulatoree. I have no question that members of your association, other investment advisers, the Commission and its staff will be able to sit down, discuss and understand each others problems and promulgate workable and effective rules in order to ferret out persons who, by reason of unscrupulousness, or dishonest and fraudulent practices, have shown themselves to be unfit to carry on the business of an investment adviser.

There are a number of minor proposed amendments to the Act, which need no discussion at this time. Before I conclude, however, I would like to mention just one further proposed amendment. There is no provision in the present Act expressly prohibiting any person from violating the Act or any rule or regulation thereunder. Furthermore, in the absence of any express statutory provisions, there may exist some doubts as to the Commission's authorities to obtain an injunction or to impose administrative sanctions against persons aiding or abetting violations of the Act. Our proposed amendments would remedy this situation by making a specific prohibition against violating the Act or any rule or regulations thereunder. In addition, it would clarify the authority of the Commission to obtain injunctions against aiders and abettors.

I truly hope that the entire industry will understand and appreciate the need for these proposed amendments and that Congress, in its wisdom, will enact them into law. Under a stronger statute, we hope and believe that the industry will be able to cleanse itself of any malpractices that now exist. We will do all in our power to help you achieve this objective.