manner causes to be issued, published, sent, delivered, or mailed, any circular, letter, publication, or message predicting the future market value or price or recommending the sale or purchase of any corporate stocks, corporate or public bonds or securities, grains, livestock or commodities, or recommends the investment of funds in or refraining from investing funds in any corporate stocks, corporate or public bonds or securities."

This definition, it may be noted, would make any regulation apply only to those who furnish advice for a consideration of value. However, it would be immaterial under the above definition whether the advice relates to stocks and bonds or to grains, livestock, or other commodities. Subject to possible refinements in language the definition quoted above may perhaps be thought satisfactory.

An analysis of the definitions found in the laws of other States gives rise to two questions concerning the definition of investment counselors. In the first place, it may be deemed desirable to make any possible regulations apply only to those who give advice concerning "specific" securities. The insertion of the adjective "specific" would be intended to exclude from regulation those who give only advice of a general economic nature.[7] Whether this is desired, would, of course, be a question of policy. Furthermore, difficulties in administration may arise as to just what constitutes advice concerning specific securities, whether it means advice as to a specific security or also includes advice concerning a class of securities. Accordingly, the use of qualifying adjectives, such as the word "specific," requires careful consideration.

In the second place, it may be thought necessary to define what constitute "securities," advice concerning which makes the action come within the scope of the proposed act. The general practice in those States regulating investment counselors is to incorporate in the act the definition of securities as given in the State blue-sky law. In addition, however, other items may also be included by enumeration. For example, New Hampshire treats as securities contracts of services or advice relating to investments, or memberships in organizations purporting to render such services or advice. Sellers of such contracts or memberships are then subjected to regulation as dealers in securities.[8]

Whether or not to add to the definition of "securities" as found in the State blue-sky law depends upon whether that definition is broad enough to cover all types of investments which it is desired to include in the Investment Counselor Act. In Illinois the blue-sky law does not cover investments relating to grains and livestock, but these are included in the definition quoted above from senate bill 601. The same bill also included a general definition of "securities" as any item, article, or thing with respect to which investment counselors give advice or predict the future value of. Such a general definition may be thought desirable in order to assure the inclusion within the act of all varieties of investments (such as whisky warehouse receipts and cemetery lots) or may, on the other hand, be thought undesirable as possibly productive of confusion if the definition of securities as contained in the blue-sky act is also incorporated by reference.

(3) EXEMPTIONS FROM REGULATION

Regulatory statutes concerning investment counselors appear to exempt from their provisions those who furnish advice without any remuneration or valuable consideration, apparently because it is thought impracticable to regulate such gratuitous services. Newspapers and journals generally also seem to be excluded although this is not explicitly stated in the statutes, the exemption apparently being based on general constitutional and legal principles. In addition various other types of counselors are sometimes excepted. Those excepted in one or more States include brokers, attorneys, banks, savings and loan associations, trust companies, and certified public accountants. The reasons for these exceptions are varied, but the basic reason seems to be that such persons and firms are already subject to governmental regulation of one type or another. Furthermore, the investment advice furnished by these excepted groups would seem to be merely incidental to some other function being performed by them. The desirability of exempting these and other persons or organizations from regulation that is thought feasible for investment counselors generally would, of course, be a question raised in Illinois. Apart from deciding the merits of each claim

[7] For such a definition see Connecticut General Statutes, 1937 supp., ch. 212, sec. 747d.
[8] New Hampshire Public Laws (1926), ch. 284, sec. 2, as amended by Laws of 1929, p. 47.

for exemption, a decision would have to be made as to whether to exempt only those who incidentally and occasionally give advice as to investments or whether to exempt as a general rule all who regularly furnish investment advice if they also belong to one of the groups in relation to which some other form of governmental regulation exists.

Various grounds may be stated in favor of exempting members of particular professions or occupations from any possible regulation as investment counselors. Thus, in the case of attorneys, adequate safeguards for the public may be thought to exist in the lawyer's liability to disbarment in case he engages in unethical practices. Similarly, banks and trust companies regulated by National and State authorities may be thought to be subject to regulation sufficiently extensive, and to adhere to a standard of conduct sufficiently high, to make it inadvisable to impose further regulations. Certified public accountants, examined, and licensed by the State, might claim exemption on that ground. Brokers and security dealers, subject to regulation by the State under the "blue sky" laws, and also by the exchanges with which they deal, may also claim to be already subject to adequate regulation.[9] To these claims for exemption from regulation various answers could be made. For example, in the case of brokers who act as investment counselors it could be said that regulation is desirable to assure that they always act in the interest of their clients, since, as brokers, they are in a position, by advising buying and selling, to make a commission on the transactions, in addition to any fee that may be charged for the investment advice which they render.

The effectiveness with which claims for exemption from general regulations could be prosecuted might seem to depend on the nature of the regulation being considered. It might be thought that if detailed regulations are adopted they should apply to all counselors, while if the regulations are less severe it might be feasible to exempt those who are already subject to equivalent regulation on other accounts. On the other hand, those investment counsel groups that do not claim exemption, or whose claims are rejected, might argue that a spirit of fair play requires that the same regulations apply to all their competitors, whether or not these competitors be also subject to regulation as attorneys, accountants, brokers, or banks.

(4) PUBLISHERS OF INVESTMENT ADVICE

A particular problem in defining the application of a law regulating investment counselors arises from the existence of individuals and firms who furnish investment advice solely by means of publications. Insofar as such individuals and firms also render specialized advice to individual clients, they might be subject to any regulatory measure that may be adopted. The question arises, however, as to whether or not services which give the same general advice to all their clients, by means of some circular or other publication, are actually engaged in a type of investment counseling as to which regulation is feasible.

The reason for considering these generalized investment services in relation to possible regulation, is to be found in the greatly varying types of news, facts, and conjectures that are circulated. Criticism is also prevalent of advertising policies which sometimes involve great overemphasis of the value of the service supplied and of the profits which can be expected from the use of such services. Then, too, question may arise as to the good faith of some of the less reputable of these generalized investment services. The situation with regard to financial publications has been summarized as follows:

"Even the honest and well-intentioned, it is doubtful whether, as a whole, these organs of news do more to inform or misinform their readers when they go beyond reporting and analyzing facts and figures.

"Often, however, they are not honest but are open to suspicion of willingly lending themselves to the use of stock market promoters and manipulators who seek to influence the course of security prices through the use of propaganda. Sometimes a single employee may be corrupted without the knowledge of his superiors. Sometimes the organization itself is corrupt. Sometimes it is the unwitting dupe of clever machinations. The worst forms of tipster sheet exist for no other reason than to lure the investor and gambler to their financial ruin. Brokers' market letters are issued in most instances for the purely selfish purpose of exciting speculative fervor." [10]

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[9] For a discussion of such claims, see the "Report of Public Hearing of Investment Counsel Firms before the Securities and Exchange Commission," Investment Counsel Annual (1938), pp. 152–3.

[10] Twentieth Century Fund, Inc., the Security Markets (1935), p. 692.

These investment services which function through publications sent to their subscribers, rather than through individualized advice, would present several difficulties not found in regulating investment counselors generally. In the first place, the large number of agencies publishing investment facts and interpretations is well known, and a very large administrative staff would be required to enforce detailed regulation. Secondly, such information is supplied both by newspapers and by specialized financial journals and services. The accepted rights of freedom of the press and due process of law might prevent any general regulation and perhaps also supervision over particular types of publications, even if the advertisements of these publications occasionally quite exaggerate the value of the factual information which is supplied. That the constitutional guarantee of liberty of the press is applicable to publications of all types, and not only to newspapers, has been clearly indicated by the United States Supreme Court in the following terms:

"The liberty of the press is not confined to newspapers and periodicals. It necessarily embraces pamphlets and leaflets. These indeed have been historical weapons in defense of liberty, as the pamphlets of Thomas Paine and others in our own history abundantly attest. The press, in its historical connotation, comprehends every sort of publication which affords a vehicle of information and opinion.[11]

To the problem of formulating reasonable and practicable regulations for the factual services must, accordingly, be added legal and constitutional difficulties inherent in the attempted regulation of any individual or organization functioning primarily by means of published circulars or volumes. However, liberty of the press is not an absolute right, and some types of regulation may be both constitutional and feasible, assuming that regulation of some sort is thought desirable. Such regulation could probably not legally take the form of licensing publications or prohibiting certain types of publications. Regulation of the publishing of investment advice in order to conform with constitutional requirements, would probably have to be confined to punishing, by civil or criminal penalties, those who perpetrate or attempt to perpetrate frauds or other specific acts declared to be contrary to law.

This seems to be the situation in the States generally and may be the only feasible course of action. It has been suggested, however, that the possibility of fraud or other illegal and unethical practices on the part of publishers of investment facts and advice could be reduced if such publishers were required to file copies of their bulletins and circulars with some State agency. The knowledge that such publications would be a matter of public record, and might serve as a basis for civil or criminal action, could be expected to have a restraining effect upon publishers. However, the requirements of such filing might also be of little effect, particularly if it appears that no effort is made by the administrative authorities to scrutinize the many documents that would be received, and a great deal of administrative effort would be necessary both to enforce the filing of publications and to initiate action founded on statements contained in such publications. Furthermore, the requirement of filing could probably not be enforced against publications issued in other States and sent to residents of Illinois.

It may be thought desirable specifically to exclude from regulation the publishers of generalized investment information, along with those who furnish only economic advice generally. This may be done by carefully defining the term "investment counselor" so as to exclude "any person or organization which engages in the business of furnishing investment analysis, opinion, or advice solely through publications distributed to a list of subscribers and not furnishing specific advice to any client with respect to securities, and also persons or organizations furnishing only economic advice and not advice relating to the purchase or sale of securities."

This possible definition is generally the same as that used by the Federal Securities and Exchange Commission in limiting the scope of its report on investment counsel organizations.

(5) TYPES OF REGULATION

Two general types of regulation exist. Investment counselors may be regulated as brokers or dealers in securities, or they may be subjected to special regulation as investment counselors. In four States (Michigan, New Hampshire, Oklahoma, and Rhode Island) investment counselors are required to

[11] *Lovell* v. *Griffin*, 303 U. S. 444 (1938).

obtain registration under the State securities law as brokers or dealers in securities. Two major reasons are offered in support of this type of regulation. In the first place, it is said that some counselors act as brokers or attempt to sell securities while others have connections with brokers or sellers of securities, so that the functioning of most investment counselors cannot readily be separated from the business of selling securities. Secondly, regulation of investment counselors by requiring registration as dealers or brokers is easier to enforce, since machinery for such regulation already exists and since experience in regulating dealers and brokers has already been acquired.

In two States (California and Connecticut) special provision is made for the regulation of investment counselors. This has the advantage of permitting the regulations to be adapted specifically to the problems that relate to investment counseling. This type of special regulation would be preferred by those investment counselors who are independent of brokers and dealers and who point out that an investment counselor who is also a licensed broker or dealer is in a position to give advice from which he can (by selling securities or handling the transaction) receive benefits in addition to his fee for rendering advice. This might give rise to questions as to whether a counselor who is also a dealer or broker can be relied upon always to give unbiased advice.

Once the type of regulation to be adopted is determined, the related detailed provisions would require consideration. Those who view investment counseling as a profession, look forward to a time when a system of examinations can be adopted as a prerequisite to the practice of investment counseling.[12] It is generally said, however, that a system of examinations is not yet feasible due to the lack of adequate standards and the fact that the "profession" of investment counseling is still in its formative stages.

Existing regulations in the States take the form or requiring registration and the filing of essential facts as to the form of business conducted, the business experience of the principal officers, conviction for crimes on their part, any denials of licenses under the securities law, and similar statements. Periodical financial reports are also sometimes required. In a few cases the required information is more elaborate, and in Connecticut copies must be submited of agreements with clients and of circulars and publications.

The license is usually granted unless certain disqualifications, set forth in the statutes, are discovered. In general, the license is issued if the firm is of good business repute, is apparently qualified to act, if certain laws have not been violated by the firm or its officers, and if fraudulent transactions are not involved. The fee for the license is an annual one, and is usually the same as that charged for a license as a dealer in securities. The license may be subject to revocation for a variety of causes.

Further indications of the type of information required for registration and of the grounds for denying registration may be found in the appendix to this report. In general, the administrative provisions regarding regulation of investment counselors are similar to those for the regulation of brokers and dealers in securities. The provisions for such regulation now in effect in Illinois could readily be adapted to the regulation of investment counselors.[13]

As has been indicated above, various types of regulatory measures could be devised. In the first place, investment counselors may be regulated specifically as such or they may be required to obtain registration as brokers and dealers in securities. In the second place, the regulation may take the form of requiring a system of examinations as a prerequisite to the practice of investment counseling, or there may merely be provided a system of registration much like that now in force for brokers and dealers in securities. Some further attention may be given to the relative merits of a system of qualifying examinations as distinguished from a system of registration based on applications submitted to the administrative agency.

A system of qualifying examinations exists in Illinois with regard to the right to practice various professions, such as law and medicine, and also with regard to the practice of certain semiprofessional occupations, such as plumbing and barbering. In all these cases, standards have been developed on the basis of which it is possible to administer a qualifying examination. The adoption of a system of examinations for investment counselors would require the development of a similar set of standards. Setting such standards would probably not

[12] *Investment Counsel Annual*, vol. 2 (1939), p. 175.

[13] These provisions may be found in Illinois Revised Statutes, ch. 121½, sec. 118e.

meet with insurmountable difficulties, even though the practice of investment counseling is still in its formative stages and even though the type of training and experience had by different counselors varies greatly.

A system of regulation based upon registration rather than upon examinations would encounter fewer difficulties. The procedure under a system of registration would involve the filing with the administrative agency of much the same type of information as is now required of brokers and dealers under the securities act. This information could include a statement of the financial net worth of the applicant. A minimum net worth of $5,000 is required in Illinois of brokers and dealers in securities and, although it may not be deemed necessary in the case of investment counselors, some such a requirement might be of value in eliminating from practice individuals and firms clearly in the category of irresponsible "fly-by-night" organizations.

Upon the basis of experience in Illinois with the regulation of brokers and dealers, certain conclusions may be drawn regarding the probable operation of a registration requirement for investment counselors. We are told that probably few applications would come from persons unable to present evidence of good business repute or lacking at least some training or experience related to investment counseling. It could, accordingly, be expected that few applications for registration would be denied. The effectiveness of a registration requirement, therefore, results mainly from threats to revoke, or actual revocation, of registration if the registrant engages in practices contrary to the statute or the rules promulgated thereunder. In addition, the records submitted in accordance with the registration requirement may be of value in supporting actions before the courts.

Another aspect of regulation which should be considered relates to possible incidental effects of regulation. The chief arguments for governmental regulation of those who give investment advice arises out of the inability of the average investor to determine for himself the qualifications or integrity of his counselor and the claims that he should therefore receive protection in this respect from some governmental agency. The opponents of governmental regulation point out that a comprehensive regulatory system, even if practicable, might have the effect of unduly restricting competition among investment counselors. They say also that a limited degree of regulation might actually be less desirable than no regulation at all, since limited regulation might give investors a false sense of assurance in dealing with investment counselors registered under the law. This follows from the possibility that, despite the fact that governmental regulation is not intended as a guarantee of the quality of the services offered, there will be some counselors who will point to the fact of their registration as evidence that the services they offer bear at least some mark of approval on the part of the State. Thus governmental regulation may be supported by those investment counselors who look upon superficial regulation as a device for making more readily salable a service concerning which there might otherwise be a great deal of suspicion. These possibilities need not necessarily outweigh the arguments in support of regulation as a preventative of possible fraud and misrepresentation or as an assurance that investment counselors possess at least certain minimum qualifications.

(6) PRACTICES WHICH MAY REQUIRE REGULATION

Sound administration may require that a statute dealing with a new subject of regulation should not attempt to deal specifically with all possible abuses, but should be sufficiently broad to allow for experimentation with the view to amendment of the act as experience is acquired. Accordingly, the enumeration below of certain practices of investment counselors is not meant to imply that each should be the subject of a specific prohibition or regulation. However, these are the practices generally recognized to be the phases of investment counsel activities most subject to abuse.

Solicitation of accounts.—Investment counselors solicit accounts in two ways, by the use of salesmen or through advertisements. In addition, some accounts are obtained without solicitation, the client being referred to the investment counselor by a brokerage firm or other person or group. Special consideration need not be given to the use of agents since, judging by the practice in other States, a regulatory measure applying to investment counselors would also apply to their salesmen. It may be noted, however, that the registration fee charged agents in these States is lower than that charged their principals.

Vigorous solicitation of clients is common on the part of nearly all investment counselors, since they are offering a service with which investors have not long

been familiar. Such solicitation may be by word of mouth, by means of advertisements, or by circulars and pamphlets. The major regulatory problem is one of reducing or eliminating claims which may involve misrepresentation, fraud, or startling promises as to the value of the service offered. Illinois has a statute which may be invoked in cases of fraud or misrepresentation. The provisions of this law are as follows:

"Whoever, with intent to sell, or in any wise dispose of merchandise, securities, service, or anything offered by him, directly or indirectly, * * * causes, directly or indirectly, to be made, published, disseminated, circulated, or placed before the public, in this State, in a newspaper or other publication, or in the form of a book, notice, * * * circular, pamphlet, letter * * *, or in any other way, an advertisement of any sort regarding merchandise, securities, service, or anything so offered to the public, which advertisement contains any assertion, representation or statement of fact which is untrue, misleading or deceptive, shall be guilty of a misdemeanor and on conviction thereof shall be punished by a fine of not less than $10 nor more than $100 or by imprisonment in the county jail not exceeding 20 days, or by both said fine and imprisonment." [14]

This statute, at least on its face, seems to cover cases where untrue, misleading or deceptive claims are made as to the value of any service offered investors. However, the efficacy of such a law depends, of course, upon the vigor with which it is enforced and upon its construction and application by the courts. Mere exaggerated claims will probably not often be prosecuted. Furthermore, many of the factual services originate in other States, so that punishment in Illinois is generally impracticable if not impossible. Finally, the statute is undoubtedly more readily enforced against those who offer some physical service than against those whose services are of an informative character.

If the statute quoted above is not deemed to guard adequately against possible fraud and misrepresentation in soliciting clients, a statute could be adopted which specifically relates to such action on the part of investment counselors. It might also be possible to provide administrative, rather than criminal remedies. In connection with a general regulatory statute, counselors might be required to deposit with some administrative officer copies of all advertising which they issue. The law might then provide that fraud or gross misrepresentation constitute grounds for revoking the grant of permission to function as investment counselor.

Contingent fees.—The larger investment counsel firms usually establish a scale of fees stated as a percentage of the value of the investment portfolio of their client. Inventories of the value of the portfolio are made at regular intervals, perhaps quarterly, and the fees are stated as a percentage of the value indicated in the inventory, although a certain minimum charge is usually specified. Under this procedure, the fees charged by the investment counselor are somewhat affected by profits made from his advice, since such profits result in increasing the value of the investments held. Likewise, losses from following the advice of counselors result in declines in the value of the portfolio, and a consequent decline in the charges for future services. Various other methods of charging for services are also in use, including a flat annual fee or a specific charge for each report made.

One method of charging for services rendered is generally criticized. This is a fee on a contingent or profit-sharing basis, where the agreement is that no charge will be made unless a profit is made from the advice. The fee charged if such a profit accrues is a stated percentage of the profit. Contingent fees may operate to induce counselors to urge their clients to speculate, since the investment counselor will earn a substantial fee if profits result from his advice, while he will suffer no cash loss if profits are not made.

The charging of contingent fees may also permit certain fraudulent practices. For example, it is said that some individuals advise one client to sell a certain security and advise another client to buy the same security.[15] In the normal course of the market, one client will profit from the advice, either by selling at a higher price than was paid for the security or by buying a security which subsequently rises in value. The adviser of such action, accordingly, is reasonably assured of profiting from his advice given on a profit-sharing basis, although the advice may have been rendered without any analysis of market conditions. The clients of such a "counselor" are being used as pawns.

None of the States definitely forbids the charging of contingent fees. This may be thought to indicate that advice to speculate and fraudulent practices are not to

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[14] Illinois Revised Statutes, ch. 38, sec. 249a.
[15] S. F. Porter, New Bait for Suckers, American Magazine (July 1939), p. 14.

be attributed to the fee system. On the other hand, it may be that regulation of investment counselors has not yet developed to the point where the regulation of particular practices can be embodied in statutes. The code of the Investment Counsel Association of America forbids members of the association from charging contingent fees, paragraph IV providing that the:

"Compensation of an investment counsel firm should consist exclusively of direct charges to clients for services rendered, and should not be contingent upon profits, upon the number or value of transactions executed, nor upon the maintenance of any minimum income."

It thus appears that at least the larger and most firmly established investment counsel organizations agree that a contingent fee system is undesirable. However, smaller or newly organized firms would probably argue that, because of the general lack of understanding as to the value of the services which they offer, effective soliciting of clients requires that they be able to sell their services with the agreement that no charge will be made unless profits or a guaranteed minimum income result from the advice furnished. Furthermore, it may be noted that the contingent fee system is said to be a practicable and profitable means of charging for investment advice rendered to small accounts, which accounts the larger investment counsel firms do not accept.[16]

The problem with regard to contingent fees may, therefore, be summarized as follows: A prohibition of such fees would be based upon a desire to discourage investment counselors from giving clients advice to speculate and to prevent counselors from engaging in certain fraudulent practices, such as giving contrary advice to two different clients. However, the adoption of a complete prohibition of contingent fees may hamper small or new counseling firms in acquiring clients. Likewise, the prohibition of contingent fees would require that some other means be devised by which the small investor could avail himself of investment advice, perhaps by more general use of a flat charge for each report made.

Advisory and discretionary accounts.—With regard to the power of the investment counselor to act in relation to the client's investments, two different types of accounts exist: Advisory accounts and discretionary accounts. The former, advisory accounts, seem to be the most common. So far as such accounts are concerned, the investment counselor gives advice as to changes in investments which he deems desirable, and he may urge that this advice be followed as promptly as possible. However, the decision as to whether action should be taken is made by the client.

Insofar as so-called discretionary accounts are concerned, the powers of the counselor are greater. He not only reaches a decision as to what securities should be bought or sold, but he also takes such action in the name of his client. Authority to do so, where it exists, is usually granted by a power of attorney.

In support of the practice of accepting discretionary accounts, various arguments may be stated. The existence of power to act makes it possible for the client to obtain immediate advantage of the advice prepared for him without delays incident to communications between the counselor and his client. Furthermore, a client may be ill, traveling, or in an inaccessible place, so that he cannot take prompt action.

Obviously, a client will not authorize a discretionary account unless he has confidence in his counselor. Some firms strongly recommend discretionary accounts, thinking them efficient, while other firms will not accept discretionary accounts, apparently being unwilling to assume the responsibilities entailed thereby.[17]

From the point of view of the public interest, discretionary accounts are significant only in that they may be used to permit fraudulent practices. For example, a counselor who has several discretionary accounts may have some connection with the brokerage house which executes his orders. He may purchase stocks through this broker. If the stocks rise rapidly immediately afterwards, he may have the purchase credited to his own account, and subsequently sell at a higher price. If the stocks decline in value, or rise only slowly, the order will be entered in the name of some client.[18] Even if the counselor has no connections with a brokerage firm, he may engage in practices which would operate to his own advantage rather than to the advantage of his clients. For example, the counselor may himself own a block of securities. If he desires the price to rise, he could place large orders in the name

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[16] Twentieth Century Fund, Inc., The Security Markets (1935), pp. 653–654.
[17] Report of public hearing of investment counsel firms before the S. E. C. in Washington, Investment Counsel Annual, vol. 1 (July 1938), p. 116.
[18] S. F. Porter, cited above.

of his clients for the purchase of the same securities. Or, if he desires the price to fall, and his clients own large amounts of such securities, he may place orders of sale in their behalf. If these transactions are large enough, they may have an appreciable effect on the market value of the securities.

These practices are not now subject to specific statutory regulation. However, laws against fraudulent practices generally may be thought to provide adequate safeguards. Furthermore, the advantages of discretionary accounts may be thought to outweigh possible danger of fraud.

If regulation of discretionary accounts is thought desirable, several types of regulation might be effective. Apart from the possibility of forbidding discretionary accounts altogether, the privilege of accepting such accounts may be limited to cases where the client is traveling, is on vacation, or is incapacitated. Some of the fraudulent practices might perhaps be avoided by forbidding counselors from engaging in speculative practices in their own accounts or from having financial connections with brokers or with dealers in securities. In each case, however, the apparent desirability of the regulation would have to be measured against the disturbing effect the regulation would have upon the functioning of reputable counselors.

Affiliations with brokers and dealers in securities.—Another aspect of the functioning of investment counselors which may require consideration is the relation of such counselors to individuals and firms who market securities or who handle transactions in securities. Many counselors have some connection, direct or indirect, with such individuals and firms, although such connections are not universal. Furthermore, brokers and dealers in securities frequently maintain an investment-counsel service in connection with their other activities. Fifty-three of the three hundred and ninety-four investment-counsel firms that replied to a questionnaire of the Federal Securities and Exchange Commission stated that they also acted as brokers and dealers in securities, or were affiliated with an organization acting in that capacity.[19]

That affiliation between an investment counselor and a broker or dealer in securities is not inherently bad may be thought demonstrated by the fact that several States do not regulate counselors as such, but instead effect regulation by requiring counselors to be registered as brokers or as dealers in securities.

The criticisms of counselors also acting as brokers or dealers are founded upon possible encouragement of practices bordering on fraud. The major danger is that a counselor connected with a brokerage house will unduly urge frequent buying and selling of securities, even when the wisest procedure might be for the client to retain existing investments. By stimulating transactions, the counselor connected with a brokerage house will increase the profits of the organization, since the fees charged are based on the volume of transactions, and some share of the profits may be paid to the counselor.

A counselor who is also engaged in the business of selling securities is in a position to buy securities and then recommend their purchase by his clients at a higher price. A possible safeguard against fraud or deception in such sales is the requirement that the client be informed that the investment counsel owns the securities offered for sale.

In Illinois, an investment adviser who sells or assists in the sale of securities must be registered as a dealer or broker and is subject to the following rule laid down by the securities department of the office of the Secretary of State:

"If a dealer or broker is also an underwriter or owner of securities being sold or offered for sale, the customer shall be specifically informed of that fact and also as to the fact that the dealer or broker is expecting to realize some other remuneration or profit in addition to the compensation for his services as dealer or broker." [20]

This may be thought to constitute adequate regulation on that point. It may, however, be suggested that a further provision be adopted requiring the customer to be furnished with a statement of the price at which the security was obtained by the seller. This would be intended to prevent the statement regard-

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[19] Securities and Exchange Commission, Report on Investment Counsel, Investment Management, Investmen Supervisory, and Investment Advisory Services (August 17, 1939), p. 14.

[20] Rules and Regulations With Reference to Dealing in Securities Under the Illinois Securities Law (effective December 1, 1938), rule 11.

ing the ownership of the security by the counselor from being made in such a way as merely to give the impression that such ownership is an indication that the security is a sound investment. The desirability of such an additional statement would depend upon whether the information would be of value to the client in deciding whether the advice to buy was given in good faith. Separation of counseling functions from brokerage and selling activities has not been attempted in any State.

Custody of funds and investments.—It appears that most investment counsel firms refuse to acept the actual custody of their clients' funds and investments. This refusal is apparently based upon an unwillingness to assume the responsibilities which such custody involves. The acceptance of the custody of funds and investments, moreover, opens the possibility of activities which may be both unethical and fraudulent. For example, if the investment counselor has custody of his clients' investments he may use them as security for personal loans. Accordingly, it may be desirable to give consideration to a possible prohibition against counselors assuming custody of funds and investments. This may, however, not be practicable, since some counselors, particularly those who also act as brokers, may find the custody of funds and investments to be necessary to efficient functioning, particularly in the case of discretionary accounts.

(7) SUMMARY

The arguments for and against statutory regulation of investment counselors are referred to in this report, but are not given extended analysis. Accordingly, this treatment of possible regulation is merely a discussion of items that might be thought to require consideration if regulation is deemed desirable and feasible.

If regulation is deemed desirable, it could be effected either by regulating investment counselors as a special group or by requiring counselors to subject themselves to regulation as brokers and dealers in securities. If it is thought more feasible to follow the latter course of action, the regulations governing brokers and dealers could be made to apply to investment counselors.

If, however, investment counselors are to be regulated as a separate group, problems would arise as to the precise type of regulation to be enforced. It would be possible to adopt a registration procedure, under which an investment counselor could not practice until his application for registration had been approved by some State agency. Even if specific registration as an investment counselor is required, such a plan would probably not be greatly different from that now enforced as to brokers and dealers in securities.

The other alternative is to provide a more comprehensive regulatory system, including a system of qualifying examinations which the applicant must pass before he could engage in investment counseling. The following quotation illustrates the type of special regulation which could perhaps be developed in relation to investment counselors:

"1. No individual should be permitted by the several States to practice as an investment counsel without a degree of certified investment counsel, and a license to be awarded after proper examination by suitable State authorities.

"2. No individual should be granted, or permitted to retain, a license to practice as an investment counsel for pay who is in the business of underwriting, distributing, buying, or selling securities either as a broker or principal; or who is in the employ of, or is in any way affiliated with, or is a stockholder or partner in, any organization engaged in any manner whatever in such activities.

"3. No licensed investment counsel should be permitted to employ, or to retain in his employment, any one in any way connected with any activity named or implied in paragraph 2, above; or to associate himself as a partner, joint stockholder, or otherwise with any such disqualified person.[21]

These constitute recommendations for legislation made by a security markets survey staff of the Twentieth Century Fund, a research organization of national scope. These suggestions, however, were not made with particular reference to the State of Illinois, and have not been adopted in any State. Furthermore, such comprehensive regulation, even if conceded to be ultimately desirable, may not be considered feasible as a first step in regulation even by those who feel that some regulatory measure is desirable.

In the case of so-called investment counselors who function only by means of publications, a special problem would arise with regard to possible regulation.

[21] Twentieth Century Fund, Inc., Stock Market Control (1934), p. 203.