

As used in this section, "investment advisory contract" means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account for another person. Paragraph (1) of this section shall not be construed to prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period or taken as of a definite date.

PROHIBITED TRANSACTIONS BY REGISTERED INVESTMENT ADVISERS

SEC. 206. It shall be unlawful for any investment adviser registered under section 204, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

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

(2) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any client or prospective client;

(3) acting as principal, knowingly to sell any security to or purchase any security from any client, unless such investment adviser is a member of an association of brokers or dealers registered with the Commission pursuant to section 15A of the Securities Exchange Act of 1934; or

(4) if such investment adviser is a member of such an association, knowingly to sell any security to or purchase any security from any client without disclosing to such client in writing at or before the completion of such sale or purchase whether he is acting as a dealer for his own account, as a broker for such customer, or as a broker for some other person.

PENALTIES

SEC. 207. Any person who willfully violates any provision of this title shall upon conviction be fined not more than \$10,000 or imprisoned not more than two years, or both.

SHORT TITLE

SEC. 208. This title may be cited as the "Investment Advisers Act of 1940".

EFFECTIVE DATE

SEC. 209. This title shall become effective on October 1, 1940.

Senator WAGNER (chairman of the subcommittee). The first witness before the subcommittee will be Judge Robert E. Healy, Commissioner of the Securities and Exchange Commission. Judge Healy, are you prepared to proceed?

Mr. HEALY. Yes; Mr. Chairman.

STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER. Judge Healy, would you rather proceed with your prepared statement and then have the members of the subcommittee propound such questions as they may desire? Or what is your preference in that regard?

Mr. HEALY. If it is left to my preference I think it would be better if I might go ahead and make my statement, and thereafter submit to such questions as the members of the subcommittee may wish to ask me.

Senator WAGNER. That will be all right. You may proceed.

Senator TOWNSEND. Judge Healy, may I state at this time that when I have to leave, about 5 minutes to 11 o'clock, I am not running out on you, but have to go to attend a meeting of a subcommittee of the Committee on Appropriations, of which I am a member.

Senator MALONEY. And I would like to state that I have to go to a meeting of the Commerce Committee, but I hope to get back in a short time. But, as you doubtless know, that is the way we live up here.

Senator DOWNEY. I can stay with you throughout.

Mr. HEALY. I am sorry that all of you gentlemen cannot remain, but we have to do the best we can.

Senator WAGNER. Every member of this subcommittee will rely upon reading the testimony when we get into a general discussion of the bill.

Mr. HEALY. I will leave with the subcommittee some copies of my prepared statement.

Senator WAGNER. Do you say you have copies for the members of the subcommittee?

Mr. HEALY. Yes.

Senator WAGNER. May we have them now?

Mr. HEALY. Here they are.

Senator WAGNER (chairman of the subcommittee). We will now proceed with the hearing. I hope everyone present will try to be as quiet as possible. I always dislike to be a disciplinarian but it is very difficult for the members of the subcommittee to hear a witness unless we have reasonable quiet in the room.

All right, Judge Healy, you may proceed. And will you speak out as loudly as may be necessary. I am sure the number of spectators present are interested in the proceedings and would like to hear your testimony.

Mr. HEALY. Mr. Chairman and Senators, my name is Robert E. Healy. I am a member of the Securities and Exchange Commission. I have had general supervision of the Commission's study of investment trusts and investment companies. I am here in behalf of the bill as a representative of the Commission, which endorses the bill and recommends to the Congress that it be adopted at the present session.

In 1935, when the Congress passed the Public Utility Holding Company Act, it included in it section 30, which not only authorized, but directed, the Securities and Exchange Commission to make a study of investment trusts and investment companies, and to report its findings and recommendations to the Congress. The members of the staff and I will attempt to outline in some detail the results of our 4-year survey of the industry, made pursuant to this mandate.

Let me try my hand at a general description of investment trusts and investment companies. Essentially these organizations are large liquid pools of the public's savings entrusted to managements to be invested. The sales and promotional literature of investment trusts and investment companies has created the impression that they are not unlike savings banks and insurance companies, except that they are not limited to so-called legal investments. The sales emphasis by promoters of investment companies has been upon the necessity for providing security for old age and for emergencies, and upon the claim that by expert management and diversification of risk, this security can be furnished by these organizations.

For example, Charles A. Kettering, vice president and research director of General Motors Corporation (and I pause to say, one of our most useful and finest citizens), testified at the public examination

that in 1930 he purchased 40,000 shares of an investment company for \$260,000 in the belief that it gave him a participation in a wide range of securities and was "akin or about the same participation you would get in, say, one of these single payment life insurance companies." He said that he did not know that investment companies were not subject to supervision as were life insurance companies or banks. Ultimately Mr. Kettering realized only \$20,000 on his investment—that is, he lost approximately a quarter of a million dollars. And, incidentally, I may add that he served as a director of that company; said he had been unable to attend meetings, and said he did not understand investments; adding, what interested me greatly, that he saw life through the laboratory window.

The interest of the public in investment trusts and investment companies has been and still is very large.

In the last 15 years approximately 1,300 such companies have been created. Speaking generally these organizations have made comparatively little original contribution of capital to industry, the investments for the most part being in securities already issued and outstanding. The reason for that I think will appear before the hearings are over. It is due, in part, to the necessity of some companies keeping themselves in a strictly liquid position. The American public, has contributed over \$7,000,000,000 to these organizations. That is on the basis of investment. You can compare that with \$14,000,000,000 roughly estimated as the investment in the electric light industry. The value of their assets at present is approximately \$4,000,000,000. At present only some 650 or approximately one-half of investment companies formed in this country, are still in existence. The other companies have disappeared through bankruptcy, receivership, dissolution, mergers, and consolidations. With respect to 22 of the bankrupt companies upon which the Commission has reasonably accurate figures, the security holders sustained a capital loss to December 31, 1935, of approximately \$510,000,000 out of a total net capital contribution of almost \$560,000,000, or a loss of about 90 percent. Altogether investors have sustained a capital shrinkage of approximately \$3,000,000,000 in all types of investment trusts and investment companies.

Many individual investment companies have total assets equal to those of the larger savings banks. Their securities are owned by approximately 2,000,000 investors throughout this country, with the majority of the individual investments in such securities having a value of under \$500. The number of security holders of investment trusts and companies probably exceeds that of all other industries except utility holding company systems. It is estimated that one out of every 10 holders of securities of all types in this country is a holder of investment trust and investment company shares or certificates.

In addition, investment companies at present control or are in a position to control or importantly influence various industrial, banking, utility, and other enterprises having total assets which, as of the end of 1935, amounted to some \$30,000,000,000. Furthermore, these investment trusts and investment companies, because of their very substantial trading in securities on stock exchanges, are a most substantial factor in our securities markets.

Because of the large public interest in these organizations, and because these investment trusts and investment companies represent

unsupervised pools of savings, these institutions have been a matter of concern to representatives of the investment company industry, stock exchanges, financial writers, and governmental bodies from the early period of their existence in this country. The potential dangers of these organizations have been indicated and with the passing years criticism has increased.

In the year 1928, for example, the attorney general of the State of New York conducted an investigation of investment trusts. He recommended that investment trusts be required to incorporate under the banking laws and be subject to the supervision of the State banking superintendent. His recommendation was not adopted, I might say.

In March 1929 Paul Cabot, who has been associated with the State Street Investment Corporation since its inception, in an article in "The Atlantic Monthly", predicted that, unless promoters in the United States avoided the "errors of false principles" committed in the early history of investment trusts in England—

* * * we (in the United States) shall inevitably go through a similar period of disaster and disgrace.

[I think his prediction has been realized]. In the opinion of Mr. Cabot, the two major abuses of the industry were: (1) the companies were being operated primarily to serve the self-interest of the sponsors rather than the best interests of shareholders; (2) investment companies were being used as receptacles for otherwise unmarketable securities, [dumping grounds, in other words.] The author stated that he had testified before a committee of the New York Stock Exchange that the common and general abuses of the investment trust promoters and managers can be traced to "dishonesty", "inattention", "inability", and "greed", and cited various illustrations in support of his contention.

Prior to June 1929, the New York Stock Exchange did not list the securities of investment trusts or investment companies. The reasons which prompted the Exchange generally to deny such listing were not specifically expressed in any rules or regulations or public statements. However, one of the members of the New York Stock Exchange who, in the early 1920's, had discussed with the Exchange officials the prospect of forming and listing an investment company, stated that the Exchange felt that these organizations were "blind pools".

The New York Stock Exchange apparently was substantially concerned with the problems of investment trusts even after their securities were admitted to listing. In 1931, the Exchange adopted some tentative requirements with respect to listing the securities of these companies, stating:

It has been urged that the public interest in investment trusts is entitled to adequate representation on directorates, and that such independent representation should be had through qualified individuals not directly affiliated either with the management of the trust itself or with its banking sponsors, if any.

I want to emphasize that recommendation of the exchange because this is a matter which will be referred to later, when the bill comes up for discussion. Now, continuing the quotation from the statement of the Exchange:

It is felt that, in default of such representation, the possibility of questionable transactions between investment trusts and their banking sponsors exists; and

that this danger may lead to the feeling that investment trusts are not always managed with an eye single to the interests of their own stockholders.

Against any such suspicion, investment trusts should be protected, and this protection will in the long run prove a benefit not only to the public but to the trusts themselves, and the banking houses with which they are at times identified.

It appears to the committee as if such protection could be most readily obtained by independent directors under whose scrutiny and friendly criticism contemplated transactions would pass for review.

This view will weigh with the committee in considering listing applications.

This committee (Banking and Currency Committee of Senate), in June 1934 in its report on stock exchange practices, discussed investment trusts and investment companies and said:

The facility of perverted uses of these companies requires that these trusts be circumscribed with protective safeguards. The record indicates that it may be necessary to simplify the capital structures of investment trusts to prevent the organizers from usurping control and a disproportionate part of the equity and yield of these trusts; to limit and prescribe the concentration of securities in a particular industry; to prevent the diversion of these trusts from their normal channels of diversified investment to the abnormal avenues of control of industry; to prohibit pyramiding of investment trusts; to completely divorce investment trusts from investment banking; to eliminate the conflict of interest between investment managers and the public; to compel full and complete disclosure of the organization, capital structure, and management of the conduct of investment trusts.

And finally, in 1935, as the culmination of this interest and these misgivings concerning the operation of investment companies, the Congress directed the S. E. C., in section 30 of the Public Utility Holding Company Act, to make the study on which I am now reporting. The inclusion of this provision in a statute dealing with public utility holding companies suggests that Congress was moved, not alone by the considerations referred to in the 1934 report of this committee, but also by the suspicion that there might exist upstairs, above the utility holding companies, various investment trusts which had not been examined by the Federal Trade Commission or the committees of Congress. As will appear later, these suspicions were well founded. There are a number of these investment trusts which were rather intimately connected with holding companies in the public utility field. [When the Federal Trade Commission reported on the North American Co. the picture painted, depicting it from the North American Co. down through the subsidiaries, was not at all as bad as it was found to be in the case of many other holding companies. The investment trust study, however, has developed some very interesting facts as to what you might call the jungle of companies existing above the North American Co. They are shown on this chart which I now offer for the record.]

Senator WAGNER. The chart will be included in the record along with your testimony.

(The chart is as follows:)