

## SUMMARY OF THE BILL

The bill contains two titles. Title I relates to investment trusts and investment companies of all types. Title II relates to investment counsel and other investment advisory services. The bill deals with abuses and deficiencies in the organization, sales of the securities, and operation of investment companies. In general the theory of the bill is to eliminate wherever possible such abuses by direct prohibition of their continuance. Only in the comparatively few cases where the problems are complex and technical is a regulatory power vested in the Commission to correct malpractices by rules, regulations, or orders promulgated in accordance with precise standards prescribed in the bill. The following resume is not a complete description of all the provisions of the bill nor of the abuses which the bill is designed to remedy.

### Investment Companies

Definitions, Exemptions and Classifications of Companies: Investment companies are substantially defined as issuers holding themselves out as engaging primarily in the business of investing, reinvesting and trading in securities, or issuers which own or propose to acquire securities (other than government securities and securities of noninvestment company subsidiaries) having a value exceeding 40 per cent of their total assets (other than government securities and cash items). The bill does not cover companies which are not investment companies. It therefore excludes companies primarily engaged, directly or through subsidiaries, in the management and operation of a noninvestment business or businesses. It also specifically excludes brokers, underwriters, banks, insurance companies, holding companies subject to the Public Utility Holding Company Act of 1935 and certain other types of companies. The bill makes provision for the exemption of employees investment companies upon such conditions as may be prescribed by the Commission. (Sections 3, 6)

Investment companies as so defined are subdivided into various types and classes according to corporate structure and investment policies, with the power in the Commission to make further subclassifications. (Sections 4, 5)

Registration, Disclosure of Investment Policies and Size: As a condition to the use of the mails and the facilities and instrumentalities of interstate commerce, every investment company is required to register with the Securities and Exchange Commission and to keep current the information contained in its registration statement. The registration statement must clearly describe the investment policy of the company. Provision is made for the simplification of the registration procedure by permitting the filing of copies of registration statements already filed under the Acts now administered by the Commission. (Sections 7, 8) No fundamental shift in the company's investment policy may be made without the vote of the holders of a majority of the company's voting securities. (Section 15).

To prevent the indiscriminate formation of investment companies, no investment company organized hereafter may make a public offering of its securities unless it has a net worth of at least \$100,000 prior to such offering. To eliminate impediments to the efficient supervision of investments, to protect securities markets, and to prevent excessive concentration of wealth and control over industry, \$150,000,000 is the maximum amount of assets which may be supervised by one management investment company. (Section 14).

Registration of Management, Depositors and Distributors: The bill provides for a simple registration with the Commission of individuals serving as officers, directors investment advisers, depositors, principal underwriters and distributors of the securities of investment trusts and companies. Registration can be denied or revoked only after a hearing and only upon the ground of conviction of a crime; an injunction by a court in connection with a security transaction; a violation of any of the provisions of this bill; or misrepresentation of material facts in the registration statement. (Section 9).

Capital Structures, Devices for, and Transfers of Control: Provision is made to eliminate in the future the evils of complex capital structures; to apportion voting power equitably among the security holders of existing companies; and to prevent unfair dilution of stockholders' interest in the company. The bill provides hereafter that investment companies may issue only common stock having equal voting rights with every outstanding share of the company's stock; and that the Commission shall on application of security holders and may on its own motion, after two years from the effective date of the bill, take steps to effect an equitable redistribution of voting rights and privileges among the security holders. The common law preemptive right of stockholders to purchase additional shares issued by their companies is restored. (Section 18) The sale of voting trust certificates is made unlawful; and rules and regulations may be formulated with respect to the solicitation of proxies. (Section 20) The bill does not contain any provision requiring the elimination from capital structure of senior securities outstanding at the present time.

In order to prevent the circumvention of the stockholders' fundamental right to elect directors (a circumvention frequently accomplished by wholesale resignations of directors and their replacement by insiders, without the knowledge of stockholders), the bill provides that directors may be replaced without a stockholders' vote only to the extent of one-third of their number. (Section 16)

To safeguard against the complete delegation of the duties of officers and directors, and against long-term and oppressive management contracts, such contracts may run for a period of not exceeding two years, if approved by the company's stockholders, and may be renewed only on a year-to-year basis, subject to the disapproval of stockholders. Management contracts must state precisely all compensation to be paid to the managers, may not provide for profit-sharing schemes of compensation, and may not be assigned. (Section 15)

Distribution and Repurchases of Investment Company Securities: To prevent the rapid and unsound formation of investment companies by promoters interested primarily in "merchandising" securities and in "switching" investors from old to new companies, and to eliminate conflicting interests, the bill prohibits the promoters of one investment company within any five-year period, from promoting and then participating in the management or securities distributions of the new investment companies. The Commission is empowered to exempt companies and individuals from this and other closely related provisions on the basis of certain prescribed standards. (Section 15) As a further deterrent to switching operations, contracts to distribute the securities of open-end investment companies may not be long-term agreements and may not be assigned. (Section 15)

While publicly offered securities of investment companies must be registered under the Securities Act of 1933, provision is made to eliminate duplication in the material filed under that Act and the present bill. (Section 24) The Commission is directed to adopt rules and regulations to protect investors against dilution of their equity caused by pricing abuses in the distribution and redemption of the companies' securities. (Sections 22, 23) To prevent grossly excessive sales loads on securities of open-end companies and of unit investment trusts, the Commission, after a hearing and after giving weight to various factors prescribed in the bill, is empowered to order the cessation or modification of such charges. (Section 22)

To prevent discriminatory repurchases of their own securities by investment companies whose security holders do not have the right to require redemption, the bill authorizes the Commission to promulgate rules, regulations and orders to prevent such discrimination. (Section 23)

Limitation on Speculative and other Activities: Investment companies may not trade on margin or participate in joint trading accounts in portfolio securities. The Commission is authorized to prevent the short sale of portfolio securities by rules and regulations. Some types of investment companies may engage in underwriting activities (if consistent with their declared financial and investment policies), while other types may engage in such activities only to a limited extent. (Section 15)

While loans by investment companies to natural persons are prohibited, loans to corporations may be made under certain specified conditions. Generally, investment companies are prohibited from borrowing, except for temporary purposes in an amount not exceeding 5% of the value of the company's total assets. (Section 21)

Elimination of Conflicting Interests: The bill requires that a majority of the board of directors of every registered investment company be persons, having no common outside affiliation and independent of those receiving brokerage, management or underwriting compensation. Certain other specific limitations upon the outside affiliations of persons who occupy important positions in the conduct of the investment company's business are also imposed. Each of such provisions is directed to a specific and dangerous conflict of duty or interest. (Section 10)

Prohibitions Against Transactions by Insiders with the Investment Companies: The bill prohibits "self-dealing" between insiders and the investment companies -- transactions with the company in which its officers, directors, managers, etc. or their affiliated companies or firms have a personal pecuniary interest. These prohibitions are concerned primarily with sales and purchases of securities and other property to or from the investment company, the obtaining of loans from the company and joint participations with the company in underwritings and other financial ventures. Gross misconduct or abuse of trust by directors, officers, managers, investment advisers, principal underwriters and distributors is also made unlawful. (Section 17) To prevent the use of the funds of investment companies to aid affiliated underwriters in their investment banking business, investment companies may not purchase securities underwritten by such affiliated persons until more than one year after the public distribution of such securities. (Section 10)

Transactions Among Pyramided and Affiliated Companies: Future pyramiding of investment companies is made unlawful by a provision forbidding the purchase by investment companies of the securities of other investment companies, except in connection with reorganization plans approved by the Commission. (Section 12, 25) The bill does not require the simplification of existing systems of investment companies.

Purchases and sales of securities between companies in the same investment company system are subjected to the scrutiny of the Securities and Exchange Commission in order to insure their fairness and their consistency with the investment policies of the companies involved and the purposes of the bill. (Section 17) The Commission is authorized by rules, regulations, or order to require that a company in an investment company system supplying management services to the constituent companies render such service at cost, equitably allocated among the various companies. (Section 15)

Cross-ownership and circular ownership of voting securities between and among investment and other companies is prohibited. (Section 20) Cross-ownership and circular ownership have had the effect in the past of giving a deceptive appearance of enhanced valuation of the assets of the investment companies concerned, attributable solely to the mirroring in each company of increased values of its own cross- or circularly-held securities.

Voluntary and Involuntary Reorganization: In order to prevent unfair plans of voluntary and involuntary reorganization, recapitalization and dissolution, the bill provides that such plans may be disapproved by the Commission if it finds, after a hearing, that they are not fair and equitable to all classes of security holders affected. (Section 25)

Accounting Practices: The Commission is authorized to prescribe uniform accounting and auditing methods and the scope of such audits; to require investment companies to file with it and to transmit to its security holders annual or other periodic and special reports; and to examine the books of investment companies. Independent public accountants for investment companies must be elected by the stockholders. Principal accounting officers including controllers of such companies, who participate in the preparation of financial statements filed with the Commission, must be elected by the stockholders or appointed by the directors. (Sections 30, 31, 32)

Dividends: Investment companies are prohibited from paying dividends derived from sources other than their net income from interest and dividends ("ordinary" income), unless expressly authorized to do so by their charters or by vote of their security holders. Investment companies with more than one class of securities outstanding may not pay dividends, unless the securities senior to the security on which the dividend is to be paid are protected by a prescribed asset coverage. (Section 19)

Fixed Trusts and Certificates Sold on the Installment Plan: To prevent the "orphaning" of fixed trusts and periodic payment plans, the bill provides that only banks and trust companies may act as trustees; requires the trust indenture to contain provisions enabling the trustee to be remunerated out of the trust funds; and prohibits the trustee or depositor from resigning except under prescribed conditions. The Commission is empowered, when any such trust has in fact become an "orphan", to bring proceedings in an appropriate Federal District Court for the distribution of its assets to its security holders. (Sections 26, 27)

To prevent the perpetration of frauds upon investors in the lowest income levels who may purchase investment certificates upon the installment plan, provision is made against excessive sales loads and excessive penalties and forfeitures for lapses and defaults. (Section 27)

Face Amount Certificate Companies: Companies which sell this type of investment contract are required to have a minimum paid-in capitalization of \$250,000 and must maintain reserves in an amount sufficient to meet the maturity value of their certificates on their due dates. Such reserves must be invested in securities of a character similar to those usually required for the investment of life insurance company reserves, and the Commission may require such investments to be deposited with corporate trustees. To eliminate excessive penalties and forfeitures, provision is made with respect to cash surrender values. (Section 28) The Bankruptcy Act is amended to provide that deposits of securities and property made with State authorities for the benefit of future certificate holders shall be void as against the trustees in bankruptcy of such companies. It is also provided that any such trustee in bankruptcy shall be appointed by the court, after giving the Commission an opportunity to be heard. (Section 29)

Other Provisions: Settlements of claims against investment companies and their officers and directors for breaches of official duty, and settlements of class suits by security holders must be approved by a court. The Commission is empowered to submit advisory reports to the courts with reference to such settlements. (Section 33)

The remaining sections of the title follow the pattern already established in the three Acts now being administered by the Commission. These sections relate to definitions; the general powers of the Commission with respect to the issuance of rules and regulations; the administration and enforcement of the Title; the right to judicial review of orders of the Commission; liability for misleading statements; and penalties for violation of the provisions of the Title.

### Investment Advisers

Registration, Revocation and Exemptions: Title II of the bill deals with investment advisory services -- individuals or organizations engaged in the business of furnishing for a consideration investment advice with respect to the purchase or sale of securities. Banks, attorneys, accountants, engineers, etc., who give investment advice only as an incident of their primary activities, are excluded from the provision of this Title. (Title I, § 45 (16).) Investment advisers are required to register with the Securities and Exchange Commission and to disclose pertinent information as to their organization, nature and character of their personnel and methods of operation.

The Commission is empowered, after a hearing, to deny or revoke the registration of any investment adviser, on grounds identical with those provided for the denial or revocation of registration of officers, directors, etc. of investment companies. (Section 204)

Conflicts of Interest and Unlawful Activities: The bill provides that it shall be unlawful for investment advisers to employ fraudulent devices in administering the funds of clients, or to engage in any transaction which would operate as fraud on the clients.

An investment adviser acting as principal in selling any security to a client is required to disclose to the client his personal interest in the transaction. (Section 203) The bill also prohibits compensation to investment advisers on a profit-sharing basis. (Section 205)

