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SEC TAKES TWO STEPS AIMED AT REGIONALIZING SECURITY REGISTRATIONS

Commission Will Provide Complete Facilities for Registering New Flotations At San Francisco, Cleveland

Benefit to Smaller Issuers Seen

The SEC recently announced two steps "designed to regionalize the registration of securities under the Securities Act of 1933" which, it is believed, will be of particular benefit to issuers of small and medium-sized issues.

These steps are:

(1) Facilities for assistance to registrants along the lines of the experiment which has been in progress in the San Francisco regional

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605 ADVISERS REGISTER

A total of 605 applications for the registration of investment advisers filed with the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940 became effective November 1, the SEC announced recently. Of the total, 312 registered as sole proprietorships, 178 as corporations, 112 as partnerships and one each as "division of a corporation", "joint stock association" and "trust." Investment advisers who are not registered under the Act are prohibited after November 1 from using the mails or any means or instrumentality of interstate commerce in connection with their business as investment advisers.

The letter of the Commission notifying each investment adviser of his effective registration apprised the registrant that under the Act it is unlawful for any person registered to represent or imply in any manner whatsoever that such person has been sponsored, recommended or approved by the Commission or that his abilities or qualifications to act as an investment adviser have in any respect been passed upon by the SEC.

"Special Compensation"

LANE DISCUSSES COUNTER BROKERS' STATUS UNDER ADVISERS ACT

SEC Counsel's Opinion Indicates Service Charges Do Not Automatically Make Registration Necessary

The SEC recently made public an opinion of Chester T. Lane, General Counsel, regarding the status, under the Investment Advisers Act of 1940, of certain over-the-counter brokers who charge an "overriding commission" or "service charge" on transactions involving the purchase or sale of listed securities through correspondent brokers who are members of a national securities exchange. The opinion was in the form of a letter to the Association, which had asked for clarification as to what constituted "special compensation" under the Act as applied to the circumstances presented.

The text of Mr. Lane's letter follows:

October 28, 1940.

National Association of Securities Dealers, Inc.,
821 15th Street, N. W.,
Washington, D. C.

Gentlemen:

"You have requested my opinion whether participation by an over-the-counter broker or dealer in transactions of the character described below renders him an "investment adviser" within the meaning of Section 202(a)(11) of the Investment Advisers Act of 1940.

Dealing in Listed Securities

"In each of the situations presented, a broker who is not a member of a national securities exchange transmits to a broker who is a member of such an exchange an order for the member broker to purchase or sell a security listed on the exchange for the account

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SEC FORMS NEW DIVISION FOR INVESTMENT COMPANIES

Schenker Heads Section; Commission Issues Rules Under Act

The Securities and Exchange Commission recently announced the formation of an Investment Company Division to carry out the duties of the Commission under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Shortly thereafter the SEC announced the adoption of amendments to its Rules of Practice to provide for proceedings for the suspension or revocation of investment advisers registrations under the Investment Advisers Act.

Schenker Appointed Director

David Schenker, who was counsel to the Investment Trust Study for several years and who has been associated with the Commission since its inception, was appointed Director of the new division. John H. Hollands will be Assistant Director.

Prior to joining the SEC, Mr. Schenker was Associate Counsel to the Senate Banking and Currency Committee to investigate stock exchange practices. He also assisted in the preparation of the report by that Committee. He is a graduate of Columbia University School of Law and was one of the editors of the Columbia Law Review. Mr. Schenker was actively engaged in the private

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COMMITTEE APPROVES DRAFT OF UNIFORM STANDARDS

Will Govern Practices in Trading in Securities in Counter Market

The goal of nationwide uniform trade practice standards, embodying the views of all sections of the country, moved a step nearer attainment re-

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"SPECIAL COMPENSATION"

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of a customer of the non-member broker. In each case the non-member broker charges his customer an 'overriding commission' or 'service charge' in addition to the regular commission which the member broker receives for executing the transaction. In no instance is the amount of the 'overriding commission' or 'service charge' greater than the regular commission charged by the member broker.

"I understand that there are four distinct practices or policies followed by over-the-counter brokers in making such charges:

Four Policies Followed

"1. Frequently the over-the-counter broker charges the overriding commission or service charge in every instance in which he transmits such an order to a member broker, and the amount of such additional commission or charge is the same for all transactions of the same size, no matter who the customer is or how much consultation or advice the over-the-counter broker has given him.

"2. Other over-the-counter brokers charge an overriding commission or service charge which may be uniform in amount, but which is charged only to those customers to whom the broker has given advice. In these cases the non-member broker receives no remuneration on transactions in listed securities if the customer has simply asked him to have an order executed, without seeking or receiving any advice.

Overriding Commissions

"3. A number of over-the-counter houses charge on a uniform basis, an overriding commission or service charge for the execution of such transactions, except that they make no charge to certain clients, for example, clients who do a substantial amount of over-the-counter business through or with the house.

"4. Occasionally an over-the-counter broker follows the practice of charging an overriding commission or service charge to all customers and on all transactions, but the amount of the charge varies in relation to the amount of consultation between the broker and his customer regarding the transaction.

Provisions of Act

"The pertinent provisions of Section 202(a)(11) of the Investment Advisers Act, under which these questions arise, are the following:

> " 'Investment adviser' means any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . ; but does not include . . . (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor . . . "

I shall assume for the purposes of this letter that, in every situation outlined above, the transaction is 'solely incidental to the conduct of . . . business as a broker or dealer.' The precise question presented, therefore, is whether in each of these situations the over-the-counter broker in taking an overriding commission is receiving 'special compensation for' advice which he may have given his customer.

Advice Often Given

"Clause (C) of Section 202(a)(11) amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause (C) which refers to 'special compensation' amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities. It is well known that many brokers and dealers have investment advisory departments which furnish investment advice for compensation in the same manner as does an investment advisor who operates solely in an advisory capacity. The essential distinction to be borne in mind in considering borderline cases, such as those which you have presented, is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental.

Specific Situations

"Let me turn now to the four specific situations as to which you have inquired. In the first situation the over-the-counter broker charges an overriding commission or service charge for participating in the execution of every purchase or sale of listed securities. While the time and expense involved in giving advice to customers may be among his motives for charging the overriding commission or service charge, they represent only one part of his general expenses, and are no more directly related to the charge which he makes than is similar advice given customers with respect to over-the-counter transactions for which the broker receives a regular commission. In this first situation the imposition of the overriding commission or service charge does not in itself make the over-the-counter broker an "investment adviser" within the meaning of the Act.

"The second situation presents a clear antithesis to the first. Here the charge is directly related to the giving of advice. Those customers who receive the advice have to pay an additional charge, while those who do not receive advice do not.

Acting as Investment Advisers

"The fourth situation is no different in principle from the second. Although all customers must pay an additional charge, at least part of the charge to customers receiving advice is attributable to such advice, and it is therefore clear that the charge includes "special compensation" for advice. It is my opinion that in both the second and fourth situations the over-the-counter broker is acting as an investment adviser.

Difficult Problem

"From a practical point of view the third situation presents a difficult problem. It is true that if the broker's discrimination between customers bears no relation to the nature or amount of advice which they receive from him, the additional charge does not in principle appear to be "special compensation." Nevertheless, I am sure you will recognize that difficult questions of fact are presented whenever the additional charge is not imposed on a wholly uniform basis. If a broker is confident that his discrimination between customers follows a clear and consistent policy, bearing no relation whatsoever to the rendition of investment advice to his customers, he may safely consider himself excluded from the definition of the term "investment adviser." When the circumstances are not so clear, I suggest that you recommend to your members that they call their peculiar problems to the Commission's attention, and take the precaution of registering under the Act pending the Commission's determination of the question. If the Commission is of the opinion that the broker is not an "investment adviser" within the meaning of the Act, he will be entitled to withdraw his registration pursuant to Section 203 (g)."

Very truly yours,

CHESTER T. LANE,

General Counsel.

QUESTIONS AND ANSWERS

QUESTION: May an over-the-counter broker or dealer who is registered with the SEC destroy his books and records (required to be kept by SEC Rules X-17A-3 and 4) immediately after going out of business or ceasing to be registered with the Commission?

ANSWER: No.

REASON: The Commission recently amended its Rule X-17A-4 to make it clear that over-the-counter brokers and dealers, among others, who are subject to Rules X-17A-3 and 4, must continue to preserve the required books and records for required periods of time, irrespective of whether or not such brokers or dealers continue in the securities business or as registered brokers and dealers. The Commission did this by adding the following new Paragraph (f) to Rule X-17A-4:

> "(f) If a person who has been subject to . . . Rule X-17A-3 ceases to transact a business in securities directly with others than members of a national securities exchange, or ceases to transact a business in securities through the medium of a member of a national securities exchange, or ceases to be registered pursuant to Section 15 of the Securities Exchange Act of 1934 . . . as amended, such person shall, for the remainder of the periods of time specified in this rule, continue to preserve the records which he theretofore preserved pursuant to this rule."

SEC DECENTRALIZATION

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office for the past six months will be extended to other regional offices.

(2) Complete registration facilities will be provided in two regional offices—San Francisco and Cleveland—for an experimental period. This will mean that registrants in those regions may file and have their registration statements examined in the regional office rather than in Washington.

The Commission intends to have both of these changes in full operation by February 1, 1941. The experiments in San Francisco and Cleveland will be in operation until October 1, 1941, at which time they will be reviewed to determine whether or not this kind of regionalization should be expanded or abandoned.

Commenting on its action, the Commission said:

Smaller Issuers Aided

"For the past six months, the Commission has provided facilities in the San Francisco regional office for assistance to registrants both before and during the process of registration. It has been found that smaller issuers in particular have availed themselves of this assistance. This plan is now being extended to the regional offices in Boston, New York, Atlanta, Cleveland, Chicago, Fort Worth, Denver and Seattle. Under this procedure, a prospective registrant may confer with registration experts in those field offices during the period when he is preparing his registration statement.

"The field office will send copies of memoranda based on these pre-filing conferences to the Washington office to aid it in expediting registration examination. Furthermore, at the conclusion of these conferences prospective registrants may ask the regional office with which they have conferred to forward the statement to Washington for official filing and examination—the regional office retaining one copy. After the statement has been filed, he may continue to discuss with the field office any questions raised by the Washington office.

Savings Expected

"Copies of all correspondence between the Washington office and the registrant are sent to the field office, and the registrant is advised that if the correspondence presents problems, he may obtain help from the regional office. The experiment in San Francisco has convinced the Commission that much time and a good deal of difficulty can be avoided in this way. It is believed that an extension of this plan to the other offices should result in substantial savings to those registrants who have otherwise felt it desirable to come to Washington to discuss personally some of the problems of registration.

"The second step—that of providing complete registration facilities in the regional offices—will, if proved successful, constitute the most far reaching administrative change ever undertaken by the Commission.

Complete Units Set Up

"Under this plan, the registrant will be able to complete the entire registration process in either the San Francisco or Cleveland regional office. Complete registration units will be set up in each of these offices. The statement may be filed there; it will be examined there; correspondence with registrants will be replaced by personal conference as frequently as possible. Pre-filing consultation will of course also be available in these two offices. It is pointed out that the Commission has decided to try this experiment in these two offices so that it may have a fair basis for analyzing the results. It has chosen these two particular areas because of their widely different industrial characteristics and geographic location.

"The Commission points out that of course it will continue to act on matters of acceleration, stop orders and similar matters. For this purpose, a close liason between the regional office and Washington will be maintained. The regional office will, immediately on filing, forward a copy of the registration statement to Washington and copies of all correspondence and memoranda on each statement will likewise be sent to the main office. Occasionally, because of the nature of particular problems, it may be found advisable to send the entire file to Washington for disposition here but every effort will be made to keep such cases to a minimum. The experiment, furthermore, will not apply to issues of public utilities subject to the Holding Company Act, or to issues of companies subject to the Investment Company Act inasmuch as the Commission has other administrative duties in these cases.

Choice Offered

"One feature of the plan to be tried in these two offices is that there will be no compulsion upon the registrant to avail itself of the facilities of the regional office. The registrant may file either in the Washington office or in the appropriate field office, and in selecting the field office it may choose either the one nearest its principal place of business or nearest the offices of its principal underwriter. During the period of the present experiment, of course, registrants having neither their own nor their underwriter's principal offices in the San Francisco or Cleveland regions will continue to file in Washington. For the purposes of this plan, the Cleveland area will include the states of Ohio, Michigan, Indiana and Kentucky. The San Francisco area will include California, Nevada, Arizona, Oregon, Washington, Idaho and Montana.

"Neither of the steps taken today contemplates an increase in personnel. The regional offices will be staffed by trained experts from the registration division.

"Appropriate changes will be made in the Commission rules to permit filing in the two regional offices before the plan goes into operation."

PRACTICE STANDARDS

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cently when a comprehensive draft of such regulations was approved by the Uniform Practice Committee of the Association. The Committee recommended their immediate submission to the Board of Governors, which is expected to adopt them in the near future.

The uniform practice standards will govern trading in securities in the over-the-counter market throughout the entire country. These regulations represent an attempt to codify and standardize existing practices. They are aimed at eliminating all possible differences in customs and usage.

Many Views Represented

In order to get the viewpoint of as many sections of the country as possible in drawing up these standards, Committee members selected for this work were picked from such widely separated points as Boston, Seattle, New Orleans, San Francisco, Chicago, and New York. It is believed that a fair cross-section of opinion on uniform practices of all sections of the U. S. has been obtained in this way.

Approval of the standards by the Committee followed a three-day meeting during which every phase of a comprehensive 17-page draft of proposed regulations was studied, discussed and passed upon. The standards will be presented to the Governors as soon as they can be drafted into final form as approved by the Committee.

64 Items Covered

The draft of the standards covered 64 items touching virtually every phase of trading. General subjects, such as the technical details of trading, delivery of securities, payment of dividends, close-out procedure, computation of interest, when-as-and-if issued trading, etc., were further broken down to cover all angles of the business.

The promulgation of such standards, it is believed, will do much to facilitate the free flow of securities between all areas in the country. The existing variations in standards result from the fact that each trading area in the country evolved its own customs through the years on the basis of usage, convenience and other factors. At present, trading between different localities, and sometimes within one locality, often gives rise to disputes and misunderstandings. National standards will place all trading on a clearly-defined basis and eliminate possible friction at its source.

NEW SEC DIVISION

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practice of law in New York City for a number of years.

Hollands Assistant Director

Mr. Hollands is a graduate of Hobart College and Harvard Law School and before his association with the Commission in 1937 was an attorney for the Petroleum Administrative Board and the NRA. He was engaged in the private practice of law in Buffalo and Canandaigua, N. Y., for several years.

Generally speaking, the procedure for handling revocation or suspension proceedings under the Investment Advisers Act will be the same as presently in effect for broker-dealer registrations under the Securities Exchange Act of 1934. The amendments become effective immediately.

The Commission also adopted a rule under the Investment Company Act granting certain companies engaged in the business of issuing periodic payment plan certificates an exemption from certain sections of the Act until December 31, 1940. The temporary exemption was provided so that those companies could bring their operations into line with the requirements of the Act in an orderly manner.

Temporary Exemption

The temporary exemption relates to Sections 24(d), 26 and 27. These Sections require that the trustees or custodians of such companies be banks having a certain minimum capitalization, that their trust indentures or custodianship agreements contain certain specified provisions, that the amount and distribution of sales load on the certificates which they issue be limited in accordance with statute requirements, and that companies confining their sales to residents of the state of their organization comply with the registration requirements of the Securities Act of 1933 from which they were formerly exempt.

Custody of Securities

The Commission also adopted a rule relating to securities placed in the custody of a company which is a member of a national securities exchange by any management investment company registered under the Act. The rule is tentative in nature, the SEC states, and has been promulgated to govern such custody during the time necessary to study and determine to what extent further regulation of the subject may be essential.

With appropriate exceptions, according to the Commission, the rule provides in effect that the member firm acting as custodian must clearly earmark and segregate such securities; that the firm may not hypothecate or pledge such securities except for the account of the investment company; and that the firm may have no lien on those securities for any purpose.

HOW COMMITTEES ARE HANDLING TYPICAL VIOLATIONS OF RULES

Excessive Profits, Unsuitable Recommendations, Factors in Case Decided by Business Conduct Committee

A customer complained to the Business Conduct Committee in her District that she had been advised by a salesman of a member firm, to sell the securities that she then owned and to purchase certain securities recommended by the member firm; and that carrying out its suggestions, the firm had sold her out of reasonably high-grade securities and put her into issues that were "almost worthless," and in so doing had reduced her income to "almost nothing." Such conduct would violate Section 2 of Article III of the Rules of Fair Practice requiring that recommendations made by members shall be suitable for the customer on the basis of the facts, if any, disclosed by the customer as to his other security holdings and his financial situation and needs.

Excessive Profits Taken

In the course of its investigation, the Committee found that there was adequate basis for this charge; and found further that, in effecting transactions for the Complainant, the member firm had apparently taken excessive profits, in violation of Article III, Section 4 of the Rules.

As a result of conferences with the Committee, the representative of the member firm proposed to cancel all the transactions executed by the firm as principal and to send adjusted statements to the customer with the firm acting on an agency basis, confirming the purchase and sale of the various securities for the customer's account at their cost price plus or less the regular broker's commission. The customer indicated that she was willing to accept this basis of settlement, and as a result received a substantial refund.

The Committee censured the member for the conduct complained of, and issued a warning that the Committee might from time to time investigate to make certain that the member no longer was violating the Association's Rules.