

If we had to define every technical trade term, in the statute, you can see what the size of this bill would be. All it says in connection with the accounting section is that we can make rules and regulations "defining accounting, technical, and trade terms used in this title." And similarly we make provision that we are to make rules in respect of classification of investment companies.

Senator WAGNER. I see that, but I still contend that being given the power to make rules and regulations in reference to all these provisions, that in itself implies the right to change or modify or rescind these rules at any time, does it not?

Mr. HEALY. Obviously, yes. I would say there is no doubt about it to my mind.

Senator HERRING. Does not that also almost have the dignity of letting you apply section 43 of the bill, which provides for a fine of not more than \$10,000 or imprisonment for not more than 2 years, or both, in case of the violation of any rule which the Commission has adopted?

Mr. HEALY. May I say in that connection that as I read this thing it does not give us substantive powers. We cannot make any new law under this. We can only implement the laws the Congress has made. We can write rules, say, on practice and procedure. We can define accounting, technical, and trade terms. We can classify them, and things of that sort. I am sure it does not give us the least power to impose any additional requirements on anybody that this law itself does not impose.

Senator HERRING. Then it is merely a regulation to implement what the law says.

Mr. HEALY. That is my view of it. And if this language is not appropriate to accomplish that result it ought to be revised.

Senator HERRING. I would not say that you are wrong, Mr. Chairman, but you see what I mean.

Senator WAGNER. I do.

Mr. HEALY. I think it is a very important question, and the Commission is most anxious, as the subcommittee is, that it be solved properly.

Senator WAGNER. Of course, I suppose this is the time to suggest questions that trouble you somewhat, Senator. When these rules are promulgated, they have the effect of statutes.

Senator HERRING. Yes.

Mr. HEALY. May I interpose something there?

Senator WAGNER. Yes.

Mr. HEALY. I think that under the decisions of the courts there are at least two classes of rules of administrative bodies. There are rules implementing statutes, the violation of which may be punishable.

Senator WAGNER. Yes.

Mr. HEALY. There are other rules that do not fall into that category, which are simply interpretative rules. For example, nobody could be put in jail because he disagreed with our definition of a technical or trade term.

Senator WAGNER. That is the very question I was coming to; that is what is troubling me.

Mr. HEALY. Our interpretative rule stating that in our opinion a certain phrase means a certain thing is just as much subject to review by a court as a formal decision with an opinion behind it, when there is a controversy that is judiciable in the courts.

Senator WAGNER. Judge Healy, I was wondering if there could not be a segregation. I do not know. In the case of a rule in which you prescribed a certain method of accounting, you would not want to make a violation of that rule to be punishable by a \$10,000 fine or by 3 years imprisonment?

Mr. HEALY. I am afraid I have to say I think I would.

Senator WAGNER. You would?

Mr. HEALY. I would think that under those circumstances the extreme penalty would be absurd and completely out of line. However, if Congress gives us the power to prescribe accounting regulations, then those regulations must be enforceable.

Senator WAGNER. Well, you may be right about that. I am just raising the question.

Mr. HEALY. Improper accounting has had some very disastrous consequences for investors—extremely disastrous. I think that proper accounting, not only in this field but in every other field, is extremely important. We have some instances of very bad accounting in some of these companies.

If you do not want to allow us to prescribe accounting regulations and then make them enforceable, then I see no alternative but for Congress to prescribe the accounting regulations itself.

Senator WAGNER. I did not go so far as to say that. I was wondering whether making that a felony is rather severe.

Mr. HEALY. Yes.

Senator WAGNER. It may not be enforceable, for that reason.

Mr. HEALY. Well, perhaps the proper method of handling that would be to make the accounting regulations enforceable by mandamus or appropriate administrative action, without making it subject to a criminal penalty. I have not thought that through.

Senator WAGNER. Well, you may be right. It may be that it is sufficiently important so that its violation should be as prescribed here.

But offhand it did seem to be a severe penalty for that violation. Now, I bow to your superior judgment in these questions.

Mr. HEALY. I state for the record that the Securities and Exchange Commission has never recommended the prosecution of anybody for inadvertent or unintentional violation of a statute.

Senator WAGNER. Well, I am not concerned that wisdom will not be exercised in its enforcement.

Senator HERRING. Speaking of accounting, it seems to me that you provide here a system of accounting and then forbid the keeping of any other record. What is that?

Mr. HEALY. It does not go quite that far.

Senator HERRING. I thought I read something like that. I wonder why you prohibit the keeping of any other records.

Mr. HEALY. If you will look at page 72, subsection (f) in section 31, you will see we expressly say they may subclassify accounts and maintain supplementary records in any manner which does not impair the integrity of the accounts.

Senator HERRING. Oh, yes.

Mr. HEALY. I think that is a rather necessary provision. As I can show you—not in the investment trust field, but I can show you in the case of the New York State subsidiaries of the Associated Gas & Electric Co.—we do find this kind of a situation: Under the

State laws they were forbidden to make certain types of entries on their books, to wit, write-ups or mark-ups of their property account. So they told the State commission that they did not make them. They did not report them to the State commission; but they kept a supplementary account in which they recorded the write-ups and mark-ups; and for several years the published reports to their stockholders included the write-ups. In other words, they were not in accord with the accounts which they reported to the Public Service Commission of the State of New York.

Now, Senator, I would agree with you if you were to say that you do not want to put accounting in a strait jacket. On the other hand, I think that if you are to preserve the integrity of accounting, you have got to have some authority about it and you have got to circumscribe it somewhat.

Senator HERRING. I did not know just the meaning of that. It appeared to forbid the keeping of any records which they might want to keep for their own convenience or use, which would have no effect on the record which you direct them to keep and which they must keep, of course.

Mr. HEALY. I should think that they should be allowed to keep any record that they pleased, that did not destroy the integrity of the accounting that was prescribed under the classification.

Senator HERRING. Yes; that is all right.

Senator HUGHES. But they would go beyond that, would they not?

Mr. HEALY. I beg your pardon?

Senator HUGHES. They would keep these supplementary accounts and, as I understand it, they would make the practice of sending them out to their stockholders; so they had the account you required and they had another account, and the facts in that they gave to their stockholders?

Mr. HEALY. That is true.

Senator HUGHES. I should think that would be misleading and very confusing and dangerous.

Mr. HEALY. Please notice I said to the Senator that I did not oppose records which did not destroy the integrity of the other record. Furthermore, as was stated this morning, we have discovered quite a number of instances—I question whether any of them are in the investment trust field; I do not remember it. However, there is in existence in the Commission a memorandum where there is pointed out the variances and discrepancies between the accounts and financial statements filed with us, under our acts, and the accounts and financial statements reported by the same corporations to their stockholders.

Now, Senator, there is a provision in this bill where that sort of thing can be corrected.

Senator HUGHES. Where is that? Is that destroying the integrity of your account?

Mr. HEALY. I think that is designed to preserve the integrity of the accounting. It is designed to see that the sworn accounts filed with the Government and maintained on their books are reported to the stockholders in that form and not in some other.

Senator HUGHES. Yes, that is what I have in mind.

Mr. HEALY. If the Senator will look at page 68, at subdivision (c) of section 30—

Senator HUGHES. Subdivision (c)?

Mr. HEALY. Yes, sir.

Senator HUGHES. Yes. Yes, I see it. That is power enough to control it, I think.

Mr. SCHENKER. I beg your pardon, Senator?

Senator HUGHES. I say I think that is power enough to control it.

Mr. HEALY. I beg your pardon, sir?

Senator HUGHES. I say that is power enough to control it.

Mr. HEALY. Yes; I should think so.

Mr. SCHENKER. Are you through, Judge Healy?

Mr. HEALY. Shall we go on to something else, or is there another point?

Senator WAGNER. Very well.

Mr. SCHENKER. Section 45 contains the general provisions and definitions, and section 46 is the separability of provisions.

Section 47 says that "this title may be cited as the 'Investment Company Act of 1940.'"

Section 48 is with respect to the effective date of the act and states that the "effective date of this title is October 1, 1940. Except where specific provision is made to the contrary, every provision of this title shall take effect on said effective date."

Then we come to title II, which deals with investment advisers.

Section 201 specifies the findings; section 202 specifies the policy; and section 203 incorporates by reference certain provisions of title I, with respect to definitions, and so forth. Now, Senator, there is a typographical error in section 203, and we should like to correct it on the record. It should read, after the colon, as follows—

Sections 3, 34 (b), 35 (b) and (c), 36, 37—

And "(e) and (f)" should be stricken out—

38, 39, 40, 41, 42—

Here "43" should be stricken out and replaced with—

44, 45, and 46.

And "47" should be stricken out.

Section 204 says that it is unlawful for a person engaged in the investment advisory business to use the mails or instrumentalities of interstate commerce unless he is registered under this section.

Then subsection (b) makes provision for an exemption which is quite tight. It says it shall not apply to investment counselors whose clients reside within one State and do not give advice with respect to securities which are dealt in on a national securities exchange or which are dealt in in interstate, over-the-counter markets. I think we have about got everybody who is in the investment counselor business.

Subsection (c) sets forth the mechanics for registration and sets forth the information which will be required by this simple registration statement.

Now, Senator, the people in the investment counselor profession may have some difficulties with the phraseology here. We are still talking to them. I think they do not disagree with the substance of the provisions.

What do we ask? We ask about their organization and personnel, including the number of employees; we ask about their education and experience and background and their past and present business affiliations. We ask the nature and scope of their business and what kind

of advice they give. Then we ask what kind of authority do they have over their clients' accounts; is it discretionary authority or do they just give advice. We ask what is the basis of his compensation, and then we ask for copies of the regular type of contract that he uses. Then we have here a provision:

such further information and copies of such further documents relating to such investment adviser, his or its affiliated persons and employees as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors.

That provision is not unlike the one that Judge Healy discussed in connection with the registration of the companies, and is not unlike the provision in section 15 (b) in the Securities Exchange Act of 1934 which relates to the registration of over-the-counter brokers and dealers.

The mechanics are that they file the application, and it automatically becomes effective. Then if the person is the type of individual set forth in subsection (d), the Commission can revoke or deny his registration. The mechanics is something like a compulsory census of the industry: "You tell us who you are." Then, if he discloses in his application or if we ascertain from independent sources that he has had a jail record in connection with a securities fraud or has been subject to an injunction in connection with a securities fraud, we can revoke his registration.

The other provision is that we can deny him registration if he has not filled out his application correctly or has told an untruth. You have to make provision for that; otherwise he will just fill in his name and file it. Then it becomes effective and we cannot hold up the registration.

Mr. HEALY. May I say that the effective purpose—whether this is the appropriate means to accomplish it or not—the real intent of this is to see to it that men with this kind of a record cannot go into the business of being investment advisers.

Then again comes this question of rubber and flexibility; because there will be cases where people have been convicted within 10 years, where the circumstances may be such that, nevertheless, it might be proper to allow them to go back into that business.

Mr. SCHENKER. The commencement of a proceeding to deny registration acts to postpone the effective date of registration; but you notice there is no provision that the institution of a proceeding to revoke or suspend his registration acts as a stay in his business.

Do you see what I mean?

Senator WAGNER. Yes.

Mr. SCHENKER. So that he can keep doing his business until the proceeding has been determined.

Then (f) is that if he ceases being an investment counselor, provision is made for the cancellation of his registration.

Section 205 is the provision which is aimed at the method of compensation. As I recall it, it was virtually the unanimous consensus of the 324 people whom we studied, with 1 possible exception, some individual in California, the unanimous consensus of the industry that what you ought to abolish is these profit-sharing abuses in the industry: "If you make any money, you turn part of it over to me; but if you lose, I don't lose anything."

It is one of those "Heads I win and tails you lose" propositions. He does not participate in the losses, but participates only in the profits. That is one of the provisions we put in the sections relating to the management of investment companies. That is to eliminate this profit-sharing method of compensation.

Section 206 is just a broad section which says you shall not do anything to defraud your client, or do anything which operates as a fraud on your client. The investment adviser cannot sell, to his client, any property or securities as principal, with this exception: Under section 15 of the 1934 act the National Association of Security Dealers was formed; and out of the 6,000 people who registered with the Commission as brokers and dealers, I think 2,500 or 3,000, over 2,800 have become members of this voluntary association which has undertaken to police itself.

We have said that a person who is a member of that association, since he is subject to the supervision of that association, may deal with the client, provided he discloses to the client that he is selling securities to the client, as principal.

Mr. HEALY. May I interrupt for just a moment?

This association is formed under the so-called Maloney Act—is the National Association of Security Dealers; I want to express the view that they have made a magnificent start and that there is every indication that they are going to do a first-class job. I say that because I do not want something else that I am going to say to be misinterpreted.

Let me also say that the investment adviser in the instance covered by the bill is principal and agent; and I suppose the argument in support of this provision is that when he acts as principal instead of agent and sells to his own client, you can permit that only if he is under the surveillance and control of that National Association of Security Dealers.

On the other hand, I personally have a little difficulty with this section; because granted that everything that I have said in favor of the Maloney Act association is true, I still have some difficulty with the idea that the right of a man or a citizen to do a certain kind of business in the United States depends upon whether or not he belongs to a certain association, however worthy.

Now, Senator, I think that fairly states the two points of view on that suggestion.

Senator WAGNER. Yes.

Mr. SCHENKER. If the committee should feel that Judge Healy's analysis of the situation is correct, then I think it is the Commission's recommendation that all self-dealing between the investment counselor and the client should be stopped. The investment counselor should not be able to sell his client any securities as principal.

The last paragraph—paragraph (4)—of that section I have described; that is no use in repeating that or in reverting to it.

Section 207 is the penalty section.

Section 208 is the short-title section.

Section 209 is the effective-date section.

Now, Senator, we should like to introduce into the record——

Senator HUGHES. Do I understand you have two views of whether he should sell to the customer?

Mr. SCHENKER. The Commission, after discussing this problem—and I think this is an accurate recapitulation; and if I am wrong, Judge Healy can correct me—the feeling of the majority of the Commission is that if he is a member of the association, then he should be permitted to sell securities as principal to the account—to the client—provided he is a member of the association and makes the proper disclosure.

Senator HUGHES. The Maloney Association does not embrace all of them in that business? That is voluntary?

Mr. SCHENKER. It is the voluntary association.

Senator HUGHES. Those on the outside cannot do this?

Mr. SCHENKER. No; the outsiders cannot do this. What Judge Healy feels a little uncomfortable about is, Why should discrimination be made? Why should the person on the outside not have that right, while the person who is in the association has that right?

Senator HUGHES. As far as I am personally concerned, without giving it any great consideration, I think there is danger in that.

Senator WAGNER. What is that?

Senator HUGHES. I think there is danger in allowing them the right to sell, and in not allowing that right to the others.

Senator WAGNER. Not allowing that right to the others—those outside of the organization?

Senator HUGHES. Yes.

Senator WAGNER. That is what appeals to me, too; I was going to raise that question myself.

Mr. HEALY. I should like to say, however, that I did not have an opportunity to discuss this section with the other members.

Senator WAGNER. You think it is all right, do you?

Mr. HEALY. They have never heard my views on this point; I happened to be away.

Senator HUGHES. I think it is a matter to which you should give some thought.

Senator WAGNER. I suppose that the distinction in that case is that they belong to an association which scrutinizes all their activities but, nevertheless, it is voluntary.

It is not scrutinized by the Securities and Exchange Commission, is it?

Mr. SCHENKER. They have to comply with certain requirements, in order to belong to the association.

Senator WAGNER. Yes.

Mr. SCHENKER. On that matter I talked to the investment bankers who also act as investment counselors, and who are affected by this provision. We had a conference and spent a whole Saturday with them. Ordinarily they would not dream of taking any inventory of securities they have on their shelf and selling them to their clients.

Senator WAGNER. Yes.

Mr. SCHENKER. They do not want that right, really, although this provision may give them this right.

The situation which they feel ought to be excluded is where they are underwriters of securities, where their client can get a little cheaper price, and their client insists, "Why should I be penalized and have to pay a little more for my security just because you happen to be my investment counselor?"

And that is true of municipals and so forth.

I do not know what great harm would result if the provision were made applicable to everybody. However, they submitted this to the Commission, and we incorporated it in that respect.

On the other hand, if a fellow feels he has a sour issue and finds a client to whom he can sell it, then that is not right, whether it is done by a member of the association or a person who is not a member of the association.

May I go on, Senator?

Senator WAGNER. Certainly.

Mr. SCHENKER. What we should like to do is to introduce into the record a recapitulation of the testimony of all the witnesses who appeared at our public examinations, who expressed their thoughts with respect to our recommendations. During the course of the public examinations that we held—and we held public examinations on 250 investment trusts, representing probably 95 percent of the total assets of the industry—we would ask, “What do you think of complex capital structures?” “Don’t you think they should have one class of stock?” “Should investment trusts borrow?”

What we have done is to take the precise question and the answer verbatim and key it into the section of the bill to which it is applicable.

I should like this to be made clear: That we have culled out only those portions of the record which sustain the recommendation. I also want to qualify it further: We have culled out portions of the testimony which sustain the recommendations, and have not included portions of the testimony which may have been against other recommendations.

For instance, a person says, “Yes; I think there should be one class of stock in investment companies.”

We asked them, “Should they borrow?”

They say, “Yes; they should be able to borrow”—although the Commission has ultimately recommended that there be no borrowings.

Senator WAGNER. Whose answers are those?

Mr. SCHENKER. Those are answers of the investment company witnesses.

Senator HUGHES. Are they now available?

Mr. SCHENKER. Some of them will be here. However, in order to make a complete record as to the members of the industry who have expressed their opinion in favor of the particular recommendations we have culled those out. If the committee wants us to get a compilation of the expressions of opinion against the recommendations, we shall be pleased to do that.

Senator HUGHES. I presume we shall get that when those witnesses come.

Mr. HEALY. I am not completely clear in my own mind whether we should offer this compilation at this time.

Senator WAGNER. We are going to hear the industry.

Mr. HEALY. Yes; you are going to hear them.

Senator HUGHES. It might be well to hold that until after you have found out who does come and what they do say. Then introduce it for those who do not come here and state their views.

Mr. SCHENKER. The only thing is that these ideas are not novel; they have been discussed with a great many people, and a great many



people found some sense in them. We are not saying that everybody who appeared was for us.

Senator HUGHES. I see no objection to using that at the end, after we have heard the other witnesses.

Senator WAGNER. Why not hold that until the end?

Mr. SCHENKER. I beg your pardon?

Senator WAGNER. Do you want to offer it, or hold it until a later date? What is the final judgment about it?

Mr. HEALY. My judgment, in view of the suggestions made here, is to hold it until a later time, and not to offer it at this time.

Senator WAGNER. Very well.

Mr. SCHENKER. I think that completes our presentation.

Mr. HEALY. I suppose it is understood that we can be heard at a later time, if desired?

Senator WAGNER (chairman of the subcommittee). Oh, yes; we do not conduct this in an inflexible manner. What the committee seeks is information.

Senator HUGHES. We probably shall want to hear them again.

Senator WAGNER. Yes.

Mr. HEALY. We shortened our presentation at the suggestion of the chairman.

Senator WAGNER. Yes; I might say that Judge Healy had a number of other examples to give us; but I thought that for the present the committee had sufficient, at least, upon which to hear the other side.

Senator HUGHES. We have had a good many.

Senator WAGNER (chairman of the subcommittee). We have finished with you?

Then who is to speak for the other side?

Mr. BUNKER. I am to speak; my name is Bunker.

Senator WAGNER. I suggest that we go on on Friday morning; that will give you all day tomorrow to prepare your presentation.

Mr. BUNKER. Yes; Mr. Chairman. Of course, we do not want to hold things up.

Senator WAGNER. Yes; I know that you do not want to do that.

Very well. You are going to open the presentation, Mr. Bunker? Will you be the first witness?

Mr. BUNKER. Yes; the first witness.

Senator WAGNER. Very well. Of course, we cannot regulate the time, because we do not know just how late we shall sit or how long you will take. We are not going to limit anybody.

Mr. BUNKER. Do you want some more names?

Senator WAGNER. We have here Mr. Bellamy, Mr. Quinn, and Mr. Bunker.

Mr. BUNKER. And then we can reappear?

Senator WAGNER. Oh, yes; we shall not be rigid about it. The only thing is that you should avoid, I think, any cumulative matter.

Mr. BUNKER. Of course.

Senator WAGNER (chairman of the subcommittee). Yes; we shall not have any difficulty about that; this is no court.

Very well; then the committee will meet on Friday morning at 10:30. Mr. Bunker will be the first witness.

(Thereupon, at 4:05 p. m., a recess was taken until Friday, April 12, 1940, at 10:30 a. m.)

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