PROTECTION OF CLIENTS' SECURITIES AND FUNDS IN CUSTODY OF INVESTMENT ADVISERS

REPORT ON EMBEZZLEMENT OF CLIENTS' SECURITIES AND FUNDS BY TWO INVESTMENT ADVISERS

and

RECOMMENDATIONS FOR AMENDING THE INVESTMENT ADVISERS ACT OF 1940

SECURITIES AND EXCHANGE COMMISSION
PHILADELPHIA, PA.
1945

SECURITIES AND EXCHANGE COMMISSION
Philadelphia

OFFICE OF THE CHAIRMAN

January 31, 1945

Sirs:

There is submitted herewith a report of this Commission containing certain recommendations for amendment of the Investment Advisers Act of 1940. The Commission was assisted in the preparation of the report by the Trading and Exchange Division, of which Mr. James A. Treanor, Jr., is Director.

Our experience in the administration of this Act over the past four years impels the conclusion that it cannot be effectively enforced in its present form. The cases of Robert J. Boltz and Albert K. Atkinson, outlined in the report, illustrate the type of fraudulent activities in which certain unscrupulous investment advisers are able to engage at present without affording this Commission the slightest overt evidence of their occurrence. We are unable to detect or prevent such activities principally because we lack the power to inspect the books and records of investment advisers--a power which we have in the case of brokers and dealers under the Securities Exchange Act of 1934.

To remedy this signal weakness as well as other related weaknesses in the Act which are described in the report, the Commission submits the attached recommendations for your examination and consideration.

We believe that this is a particularly appropriate time for adoption of the suggested amendments. If the experience of World War I is any guide, many persons will be solicited when this war ends to buy corporate securities with their excess cash and with the proceeds of their matured or redeemed bonds. Moreover, a marked increase in securities trading by uninformed and inexperienced investors will probably occur. While we trust that investment advisers generally will offer a guiding and helpful hand to these novices, our experience warns us that some advisers may avail themselves of this opportunity for exploitation of the gullible.

The report does not intend to cast reflection upon investment advisers generally. On the other hand we believe that the Boltz and Atkinson cases may not be disregarded and the assumption indulged in that similar situations will not occur.

We wish to emphasize that the proposals mentioned in the report are limited to those which we believe are most urgently necessary for the protection of the funds and securities of the clients of certain investment advisers.

It should be added that the questions in this field with which the Commission is concerned have been discussed with Mr. Robert G. Page, attorney for the Association of Investment Counsellors. Although the representatives of the industry recognize the problem and have been very cooperative in discussions concerning it, no agreement has been reached with them concerning the manner in which the necessary protection can be afforded.

By direction of the Commission:

Ganson Purcell
Chairman

The President of the Senate
The Speaker of the House of Representatives
Washington, D. C.

INTRODUCTION

As of December 31, 1943, 718 investment advisers were registered with the Commission, while at least 191 additional investment advisers have claimed to be exempt from registration. Of the registered investment advisers, 128, or 17.8 percent, state that they accept or will accept custody of their clients' funds and securities. A total of 256 registered investment advisers, or approximately 36 percent, accept or will accept discretionary powers over their clients' funds and securities.

The Commission, lacking authority under the Investment Advisers Act to inspect the books and records of investment advisers, has no means of ascertaining the correctness of the representations made in connection with registration, and no authority to determine whether a greater percentage have accepted custody of clients' securities and funds or to determine the amounts of funds and securities held by investment advisers. What is also most important, the Commission has no authority to make periodic inspections to determine whether the funds and securities of clients are intact. The mishandling of clients' funds and securities by such investment advisers as choose to do so is facilitated by the confidential character of the relationship between investment advisers and their clients.

The Investment Advisers Act thus deals with a field with respect to which neither the Commission nor any other government agency can do more than set punitive machinery in motion after the public has been defrauded. This would be insufficient protection in ordinary times, but now, when the wealth of the public is greatly increasing because of war-time conditions, the area in which fraud upon the public can operate is largely increased. Prevention is more desirable and valuable.

These considerations are supported by the following case histories of Albert E. Atkinson and Robert J. Boltz:

I. CASE HISTORIES OF ALBERT E. ATKINSON AND ROBERT J. BOLTZ

(a) Albert E. Atkinson. In September 1941, a member of the Commission's staff attempted several times to make a routine inspection of the books of Atkinson, who was registered with the Commission both as an investment adviser under the Investment Advisers Act of 1940 1/ and as a broker-dealer under the Securities Exchange Act of 1934. 2/ Each time he was unsuccessful because of Atkinson's absence. When he was finally able to confer with Atkinson, the latter stated that he conducted only an investment advisory business, and that he had but five or six clients, each of whom paid him an annual fee of $5,000. He said that he did not do business as a broker or dealer and that he maintained his broker-dealer registration with this Commission so that it would be available to him when and if he should desire to engage in the securities business. He stated that he did not have custody of customers' securities or funds; that he did not buy from or sell to the public as a dealer; that he did not place or execute customers' orders; and that, since his sole function was that of selling investment advice, he kept no

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1/ 15 U. S. C. § 80b-1 et seq.

2/ 15 U. S. C. § 78a et seq.

books or records except a check book. Since the Commission possessed no evidence to the contrary, and since under the Investment Advisers Act it had no powers of inspection, the matter was closed.

Subsequently information was obtained indicating that Atkinson's business was not as limited as he had claimed. There was evidence, for instance, that he had custody of customers' funds and securities; that he had at least one account with a member firm in his own name through which transactions were effected for customers; and that he held discretionary authority over the accounts of many clients.

Following receipt of this information, members of the Commission's staff interviewed certain of Atkinson's clients. The latter were reluctant, however, to furnish any information or to permit any examination of their own records without a subpoena. Our Cleveland office attempted again to secure access to Atkinson's books and records. He made no outright refusal of such access, but offered a series of excuses for delays. For example, at one time he admitted carrying a few margin accounts and promised to make his records available on July 21, 1942, at his office. At the time set for the inspection the office was found to be locked. Atkinson subsequently asserted that his records were in a New York bank and would be forwarded within a few days. Thereafter Atkinson's attorney advised members of the Commission's staff that he would not submit the records for examination until he had had an opportunity to study the case. No date for such examination was ever designated.

On August 4, 1942, a formal order of investigation was issued by the Commission. One customer who was interviewed pursuant to the order disclosed that he and related persons had equities of some $600,000 in Atkinson's custody. 3/ The witness was so certain about Atkinson's honesty that he consulted an attorney to determine whether he should submit to questioning. The witness' attorney, on learning of the investigation, advised him to withdraw at least a part of his equities from Atkinson at once.

Pursuant to this advice, this customer and another called upon Atkinson and demanded the return of part of their securities and funds. Atkinson had assured them prior to their coming that they could have their money whenever they wanted it. When they came in he gave one of the customers checks aggregating $150,000 and the other a check for $50,000. He then entertained both customers at golf, lunch and dinner.

The day after the two customers left Cleveland, Atkinson attempted a three-way "kite" by depositing worthless checks in various banks in such manner as to create the illusion that he had substantial balances in each of them. His obvious purpose was to create the semblance of having sufficient funds to meet the checks issued to the two customers, apparently with the idea that as soon as they found the checks were good they would return the funds to him, as had been the situation in previous cases. With respect to one of the customers, at least, this judgment proved correct, for the one to whom the $50,000 check had been given decided not to deposit it, feeling that his confidence in Atkinson had been vindicated. The other, however, attempted to collect upon his checks, but failed because of the banks' discovery of the attempted "kite".

3/ These equities were in accounts of the witness, certain of his relatives, and a company of which he was president.

The recipients of the checks then arranged that they and other customers would have a conference with Atkinson on September 2, 1942, with respect to their accounts and the "rubber" checks. Before the meeting took place, however, Atkinson committed suicide.

Following his death, the Commission ordered the investigation to continue and, as a result, much of the story concerning Atkinson's fraudulent activities was learned. The lack of books and records, however, necessarily makes the story incomplete.

When the administrators of Atkinson's estate opened his safety deposit box, no books and records were found. 4/ A similar situation existed in Atkinson's office. Solely by chance various cancelled checks and check stubs were found behind the panelled walls of the office. These afforded a lead to his activities and financial condition.

By following all available avenues of information, it was learned that Atkinson had had a total of about 150 clients during the ten years of his operations. Of these, approximately 80 made statements to members of the Commission's staff. It developed that these clients had placed about $1,700,000 in cash and securities in Atkinson's hands and had received back approximately $1,100,000, with an indicated loss of $600,000. His assets so far located amount to approximately $25,000. 5/ Shortly before his death Atkinson had sent them statements indicating that their equities totalled about $1,500,000, some of which may have represented fictitious profits reported to such customers. His clients, by and large, were wealthy individuals residing in Michigan, New Jersey, Missouri, California, Illinois, Florida, and Ohio, although most of them lived in and around Cleveland. Their equities ranged from $1,000 and $2,000 to several in excess of $100,000.

Atkinson constantly gave the appearance of financial responsibility and affluence; his office created the same illusion. His clients trusted him implicitly. Many of them believed him to be a market wizard. Most of them entered into no formal agreement with him regarding his services, but simply turned over their securities or funds to him upon the oral understanding that he would have full discretionary authority to buy and sell securities for them and invest and reinvest the funds, merely sending them statements from time to time.

His compensation was invariably based upon a share of the clients' capital gains, which is directly contrary to the representation he made to a member of the Commission's staff, namely, that he charged an annual fee of $5,000 to each customer.

The Commission has never been able to obtain a clear-cut and definitive picture of Atkinson's activities. This is due, to a great extent, to the fact

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4/ A suicide note was found, dated July 17, 1942.

5/ "Bookies" have identified Atkinson as the man who, in the last few weeks prior to September 2, 1942, bet sums as large as $30,000 or $45,000 on "long shots."

that Atkinson kept no books and records other than the aforementioned checks and stubs, which at best may be likened to a broken and scattered jigsaw puzzle. Had he been required to keep books and records as an investment adviser, had he been required to have written investment advisory contracts, and had his investment advisory business been subject to inspection by this Commission, his defalcations would very likely have been detected much sooner.

(b) Robert J. Boltz. The Boltz case broke a few days before the Investment Advisers Act became effective. He had operated an investment advisory business in Philadelphia for more than thirteen years, but had not been registered as a broker-dealer with either the Pennsylvania Securities Commission or this Commission. About the middle of October 1940, representatives of the Pennsylvania Securities Commission called on him and requested permission to examine his books and records. He refused, asking for a day to consider it, and promptly disappeared. The Pennsylvania Securities Commission informed this Commission's New York office of the facts and both agencies collaborated in the ensuing investigation.

Events thereafter moved swiftly. On Saturday, October 26, 1940, the Pennsylvania Securities Commission obtained a warrant for Boltz' arrest, charging that he had operated an investment business without a license. On October 28, 1940, Alexander Conn, a Philadelphia lawyer, was appointed receiver on petition of four of Boltz' creditors, including three of his employees. On December 10, 1940, Boltz was indicted by a federal grand jury on 21 counts involving the fraud sections of the Securities Act of 1933, the fraud provisions of the Securities Exchange Act of 1934, and the mail fraud statute. On December 30, 1940, Boltz was indicted on state charges of embezzlement and fraudulent conversion (185 bills of indictment containing 577 counts).

On February 13, 1941, Boltz was apprehended in Rochester, New York, where he had been living since his disappearance. He had found employment in Rochester as an insurance salesman under the name of James Benton.

Boltz pleaded guilty to the state charges on February 19, 1941, and was sentenced to 20 to 40 years' imprisonment on February 24, 1941. He also pleaded guilty to the federal charges and was sentenced to 20 years in prison on February 28, 1941, the sentence to run concurrently with the state court's sentence.

On August 25, 1942, the receiver announced that the 180 creditors who had established claims would shortly receive a 2% initial payment and that not more than 3½% would be returned on the $1,500,000 in cash and securities entrusted to Boltz for investment.

Robert J. Boltz was born in Philadelphia on February 13, 1887. He was educated in the best private schools of the city and was a graduate of Massachusetts Institute of Technology and the University of Pennsylvania Law School. Boltz started to practice law after graduating from law school in 1920. He commenced to give financial advice to his clients in 1925, and first handled the securities and funds of clients in 1927.

His method of operation was swift and sure. A client would turn over to him securities, cash, or possibly both, with which to open an account. Securities were almost immediately converted into cash. Through fictitious entries of purchases and sales, the client's account was built up to show

holdings of various issues and a substantial profit over the amount originally entrusted to him. Actual transactions in securities were for the most part for his own account, the only real dealings for clients being the sale of the stocks or bonds turned over to him.

In each case a contract was signed, in which Boltz agreed to pay the client 6% per annum with no return to himself except a fee of one quarter of all profits realized in excess of the 6%. This contract gave Boltz full discretionary power to buy and sell securities entrusted to him and to invest and reinvest the funds coming into his possession. Statements were rendered quarterly and the "profits" either paid to the client or permitted to accrue in the account as principal.

The growth of Boltz' business was gradual, starting with one account of about $60,000 in 1927. In 1932 there were eight or ten; 1937 found 45 to 50, and in 1940 he had about 180 clients who had entrusted him with approximately $1,500,000 in funds and securities.

As in the case of Atkinson, Boltz gave every appearance of success and financial responsibility. His clients obviously had the utmost trust and confidence in him. He had a reputation in the community which was above reproach. In fact, for some time after his disappearance his friends refused to believe that there was anything wrong.

As stated earlier, the Boltz case occurred prior to the effective date of the Investment Advisers Act, but it indicates the type of hazard which may well be prevented or minimized by effective use of a power of inspection, implemented by a requirement of maintenance of books and records and the related matters discussed hereafter.

II. LACK OF ENFORCEMENT PROVISIONS NECESSARY TO PROTECT CLIENTS' FUNDS AND SECURITIES

The two cases just related exemplify the manner in which the embezzlement of clients' securities and funds can occur without discovery under the Investment Advisers Act so long as the investment adviser is nimble enough at juggling his accounts to keep his clients deluded and unaware of the harm being done to them. Under such circumstances, there is usually no overt indication of wrong-doing. And, where no facts indicating fraud appear, the Commission is powerless to act.

(a) Lack of Power to Inspect Books and Records. The Investment Advisers Act, as it now stands, contains no grant of power to inspect the books and records of investment advisers, and authorizes the Commission to institute investigations concerning violations of the Act only when it appears that its provisions have been or are about to be violated [Section 209(a)]. Therefore, unless the Commission possesses facts sufficient to bring its investigative powers into play, it has no authority to examine the books and records of investment advisers to determine whether clients' funds and securities are safe.

In this respect, the Investment Advisers Act differs from the Securities Exchange Act. The latter Act [Section 17(a)] does confer upon the Commission the authority to inspect the books of brokers and dealers and the power has

been of incalculable aid in safeguarding the interests of customers.

The impotency of the Investment Advisers Act, in this connection, was not an oversight. The original bill contained a section which would have given the Commission broad powers of investigation and inspection, but as a result of opposition by investment advisers this section was deleted.

The reason given for the omission of the power to make inspections was the fear of the industry that the confidential relationship existing between the investment adviser and his client might be violated and confidences disclosed. This argument, in the light of the Commission's record under the Exchange Act, is not convincing. No claim can justly be made that the Commission has broadcast information obtained in broker-dealer inspections; such information is made public only when disclosure has been necessary to the enforcement of the Securities Exchange Act. No reason can be advanced why information obtained in the course of similar inspections of investment advisers will be made public, except where disclosure is essential for similar purposes.

On the other hand, the possibility of danger to clients who entrust their securities and money to unscrupulous investment advisers with discretionary powers over such funds and securities is exceedingly great when the Commission has no right to make routine inspections of books and records of investment advisers. The Atkinson and Boltz cases illustrate this danger and the further fact that the old adage, "an ounce of prevention is worth a pound of cure," has not lost its vitality.

The Atkinson case illustrates also how the power to inspect conferred by the Securities Exchange Act is ineffective with respect to investment advisers who are also brokers and dealers. Because of the limitations placed upon it by the Investment Advisers Act, the Commission has concluded that it is inappropriate to utilize its powers of inspection under the Securities Exchange Act to examine records dealing exclusively with the investment advisory aspects of a broker's business. For the same reason, the Commission has not attempted to utilize its powers of inspection under the Securities Exchange Act when it has no evidence to belie a broker's assertion that his registration under that Act is solely of prospective value in that he does no business as a broker or dealer.

While the power to inspect books and records is essential to the prevention of the embezzlement of clients' funds and securities, it should be noted that a valuable by-product of the power would be the added ability to enforce various existing provisions of the Investment Advisers Act. 6/

6/ For example, the power to inspect would be of invaluable assistance to the Commission in determining whether there has been compliance with the sections requiring registration [Section 203(a)], forbidding profit-sharing contracts [Section 205(1)], making unlawful the employment of fraudulent schemes [Sections 206(1) and (2)], forbidding the effecting of transactions in securities with or for customers under certain circumstances unless the customer is fully informed and consents thereto [Section 206(3)], and regulating the use of the term "investment counsel" [Section 208(c)]. For further details concerning those provisions, together with certain statistics relating thereto, see the Appendix to this report.

(b) Books and Records. A grant of power to inspect books and records would not of itself be adequate to protect clients' funds and securities from embezzlement. The power to inspect would be of little value in the absence of a requirement to keep books and records, for without them a complete and accurate picture of the financial condition and operations of an investment adviser cannot be obtained. 7/ For example, without books and records it cannot be determined readily whether customers have deposited securities and funds with the investment adviser, whether the customers' instructions have been followed, or whether securities and funds have been misused or fraudulently appropriated. Also, without books and records it is exceedingly difficult to check the manner in which discretionary powers over customers' funds and securities have been exercised. The Commission has discovered too often that holders of discretionary authority have misused it to their own profit. 8/

Moreover, aside from the question of probity, it is obvious that the safety of customers' funds and securities very often depends upon the financial condition of the investment adviser. The lack of a requirement to keep books and records enhances the possibility that unsound financial conditions will remain undetected and, in direct proportion, increases the possibility of dissipation of customers' assets.

(c) Oral Investment Advisory Contracts. Customers' securities and funds on deposit with investment advisers would be further protected by a requirement that investment advisory contracts be in writing, a provision which the Act does not now contain. This safeguard would afford an additional means of preventing an investment adviser from hiding from the Commission the fact that he has certain clients who may have left securities in his custody. 9/

(d) Fraud Sections Inapplicable to Unregistered Investment Advisers. Section 206 of the Act, the fraud section, now is applicable only to fraudulent activities by registered investment advisers. This is in contrast with the fraud provisions of Section 15(c) of the Securities Exchange Act of 1934, which apply to any broker or dealer, whether or not registered with the Commission. Obviously embezzlement is embezzlement, whether or not the adviser is registered. Similarly, all other activities deemed fraudulent by the Act operate to deceive investors whether or not the adviser is registered. Yet

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7/ This is recognized by the Securities Exchange Act of 1934 [Section 17(a)].

8/ Here again, the proposed amendment would provide incidental benefits in the enforcement of existing provisions of the act. See, in particular, the discussion with reference to Sections 203(a), 205(1) and 206 in the Appendix.

9/ Investment advisory contracts must provide that they are non-assignable without the clients' consent [Section 205(2)]; they must provide also for notice to the client when the make-up of a partnership investment adviser changes [Section 205(3)]. Moreover, profit-sharing contracts are forbidden [Section 205(1)]. The adoption of a requirement that investment advisory contracts be written would minimize to a great extent the present difficulty of checking compliance with these provisions.

these activities are not prohibited to unregistered investment advisers under the present wording of the Act. Moreover, in view of that fact, the Commission's ability even to bring such activities to the attention of appropriate authorities for punishment is well-nigh non-existent. This is due to the fact that Section 209(a) limits the Commission's power of investigation to those activities which violate the "provisions of this title . . ." Finally, even though such fraudulent activities on the part of unregistered investment advisers may come to light, no proceeding for injunction can be brought against such persons under the Act. These are protections to unscrupulous investment advisers which are obviously unwarranted.

III. PROPOSED AMENDMENTS

In this section the Commission recommends no more than the minimum of proposals it considers essential to protect the securities and funds which customers may place in the custody of their investment advisers.

No attempt is made to suggest all amendments to the Act which might properly be made to effectuate a complete program of regulation of investment advisers. As indicated at the time of the hearings on earlier drafts, the Act was designed to do little more than to make it possible to take a census of the persons engaged in the investment advisory business, to obtain information concerning their practices and economic import, and to provide limited sanctions against certain patent frauds. 10/ While the Commission could very

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10/ Senate Subcommittee Hearings, Investment Trust and Investment Companies, on S. 3580, Part 1 (1940), p. 48, wherein Mr. Schenker, for the Commission, stated:

"Now, we canvassed every source of information we could and we learned of the existence of 394 investment counselors. That, in my opinion, does not even approximate the number of people who are engaged in this profession, or business, or type of activity. After all, the only way we could get the list was through the telephone directories. But there are many who do not even have telephones or have their offices in their hats. We could not obtain any information about them.

"Therefore, our fundamental approach to this problem is in the first instance, before we could intelligently make an appraisal of the economic function or of the abuses which might exist in that type of organization, to see if we could not get something which approximated a compulsory census. Fundamentally that is the basic approach of title 2. We first would like to find out how many people are engaged in this business, what their connections are, what is the extent of their authority, what is their background, who they are, and how they handle the people's funds.

"Aside from that fundamental approach, the only other provisions in that title are just a few broad general provisions which say that you cannot embezzle your client's funds or you cannot be guilty of fraud. One other provision relates to the transfer of the contracts which a client makes with investment counsel. I will elaborate on those provisions at a subsequent date."

well suggest numerous amendments to the Act which would have the general effect of improving its enforcement and administration, it is reluctant to do so under present conditions. Nevertheless, there are certain amendments — those pertaining to the protection of customers' securities and funds — which the Commission feels are so necessary that it cannot avoid submitting them if it is to carry out its responsibilities to the public.

Accordingly, the following proposals are recommended:

(a) The amendment of present Section 204 to read as follows: 11/

"Sec. 204. [Every investment adviser registered under Section 203 of this title shall file with the Commission such annual and special reports, in such form as the Commission by rules and regulations may prescribe for the purpose of keeping reasonably current the information contained in the registration application.] Every investment adviser who makes use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser shall make, keep and preserve for such periods, such accounts, correspondence, memoranda, papers, books and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors."

Explanatory Note

This amendment would enable the Commission to require the keeping of appropriate books and records as it may under the Securities Exchange Act of 1934 with respect to brokers and dealers. It also would permit the Commission to make reasonable periodic or special examinations and inspections of such books and records. It goes without saying, of course, that information obtained in the course of such inspections will be kept confidential, except where disclosure is necessary for the enforcement of the Act or in the public interest, within the limitations of Section 210 of the Act.

(b) The amendment of Section 205 by adding a paragraph requiring that investment advisory contracts be in writing and by making resultant changes in numbering of the remaining paragraphs of the section. As amended, the section would read as follows:

"Sec. 205. No investment adviser registered under Section 203 shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew any investment advisory contract, or in any way to perform any

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11/ In this and following proposals, proposed new material is underscored and material proposed to be deleted is placed in brackets.

investment advisory contract entered into, extended, or renewed on or after the effective date of this title, if such contract —

"(1) is not in writing;

"(2) /1/ provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;

"(3) /2/ fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract; or

"(4) /3/ fails to provide, in substance, that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change.

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 a person other than an investment company. Paragraph (2) /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 as of definite dates, or taken as of a definite date."

Explanatory Note

This amendment would add a requirement that investment advisory contracts be in writing. It would apply to any new contract and to any extension or renewal of a pre-existing one. This requirement would not add any serious burden upon investment advisers. A mere exchange of letters might well be sufficient under most circumstances. And in any event, the added burden, if any, would be insignificant by comparison with the advantages to clients and by way of aid to enforcement of the Act.

(c) The amendment of Section 206 by deleting the words "registered under Section 203." As amended, the section would read as follows:

"Sec. 206. It shall be unlawful for any investment adviser /registered under Section 203/, 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 as a fraud or deceit upon any client or prospective client;

"(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such

client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

Explanatory Note

This amendment has been commented upon amply heretofore. It would make it possible for the Commission to bring proceedings to enjoin unregistered investment advisers from committing fraudulent acts and to set the wheels in motion whereby such persons might be punished for fraudulent acts.

This amendment would also give customers an additional remedy against unregistered investment advisers who are guilty of fraud by reason of the fact that Section 215 would be operative. That section declares void any contracts made in violation of the Act.

(d) The amendment of the caption of Section 208 by expanding it to read "Unlawful Representations and Activities" and by adding a new paragraph (d) reading as follows:

"(d) It shall be unlawful for any person registered under Section 203 of this title to take or have custody of any securities or funds of any client unless his application for registration as amended or as supplemented by the most recent report on file with the Commission discloses that he does or may have such custody.

Explanatory Note

As explained in Part II (and illustrated in Part I), customers who entrust securities or funds to their investment advisers are not afforded adequate protection under the Act. Any honest investment adviser who expects to take and hold custody of a client's funds and securities should have no objection to disclosing that that practice is a part of his business. Failure to make such disclosure is an impediment to effective enforcement and, where the failure is wilful, would in itself be a violation of the Act.

(e) The amendment of Section 210(c) to read as follows:

"(c) No provision of this title shall be construed to require, or to authorize the Commission to require any investment adviser engaged in rendering investment supervisory services to disclose the identity, investments, or affairs of any client of such investment adviser, except insofar as such disclosure may

be necessary or appropriate in a particular proceeding, ex-amination, or investigation having as its object the en-forcement of a provision or provisions of this title."

Explanatory Note

This amendment would amend the statutory admonition to the Commission to avoid requiring the production of confidential information from investment advisers performing investment supervisory services, so as to give recognition to the proposed amendment to Section 204.

APPENDIX

In Part II we have set forth proposed amendments which are necessary for the protection of customers' funds and securities held by investment advisers. We have also, from time to time, made passing references to various incidental, though substantial, benefits which would result from the adoption of the proposed amendments. For example, the enforcement of certain sections of the Act summarized below would be greatly facilitated by their adoption. The detailed information concerning these sections is set forth in the following paragraphs for the sole purpose of presenting to the Congress a more complete picture of the benefits which would flow from the adoption of the amendments proposed above.

(a) Section 203(a). Under this section it is unlawful for an investment adviser to make use of the mails or any means or instrumentality of interstate commerce in connection with his business activities, unless he is registered with this Commission. There are some investment advisers who are not so registered and who, it is believed, should be registered. The power to inspect books and records would be a ready means for checking the facts asserted as bases for claiming exemption from registration. The statistics concerning registrants and the reasons for claiming exemption from registration follow:

(1) Only 713 investment advisers were registered as of December 31, 1943.

(2) About 191 investment advisers have claimed either that they are outside the definition of "investment adviser" [Section 202(a)(11)] or that they are otherwise exempt from registration under the Act.

A. Those who claim that they are not encompassed by the definition have stated *inter alia* that:

1. they are brokers, dealers, or professional persons whose performance of investment advisory services is solely incidental to their business within the meaning of subsections (B) and (C) of Section 202(a)(11), and, in the case of brokers and dealers, is not for any special compensation;

2. they are publishers of publications of general and regular circulation within the meaning of subsection (D) of Section 202(a)(11).

B. Most of those who claim they are exempt from registration state that they have fewer than 15 clients and do not hold themselves out generally to the public as investment advisers, within the meaning of Section 203(b)(3).

(b) Section 205(1). Under this section it is unlawful for any registered investment adviser to enter into, extend, or renew any investment advisory contract, or in any way to perform any investment advisory

contract entered into, extended, or renewed on or after the effective date of the Act (November 1, 1940), if such contract provides for profit-sharing arrangements between the client and the investment adviser.

(1) About 26 registered investment advisers still had profit-sharing arrangements in effect as of December 31, 1943. Each is claimed to be valid under the Act as having been a part of a contract which was entered into prior to the effective date of the Act and which continues in effect without the necessity of extension or renewal.

(2) Some of those who had profit-sharing agreements prior to the effective date of the Act have been considering the adoption of various schemes in an attempt to avoid the prohibition against such agreements. The following have been considered:

A. The client will lend money to the firm and the firm will invest it, each sharing in the profits.

B. The firm will charge a regular fee based upon the capital investment of the client, but will expect a bonus or gratuity if investments are successful.

C. The firm will charge a regular fee based upon the capital investment of the client, but will agree to allow a rebate if investments are not successful.

D. The firm and the client will enter into joint trading accounts in which the investment adviser will contribute a small amount of capital, but will receive compensation on an equal profit-sharing basis.

The power to inspect books and records required to be kept under the Act, together with the obligation that contracts be written, would enable the Commission to determine whether evasions of the prohibition against profit-sharing contracts were being practiced.

(c) Section 206. This section makes it unlawful for any registered investment adviser to employ any device, scheme, or artifice to defraud any client or any prospective client or to engage in any transaction, practice, or course of business which operates as a fraud or deceit on any client or prospective client. It further forbids any such investment adviser, acting as principal vis-a-vis his client, or acting as broker for a person other than the client, knowingly to effect any sale or purchase of a security for the client's account without disclosing to such client in writing the capacity in which he is acting and obtaining the client's consent to the transaction.

As stated in the text of the Report, the Commission has found that fraud is made particularly easy where discretionary authority over securities and funds has been conferred by customers. It happened in the Boltz and Atkinson cases, and has occurred in the case of brokers and dealers subject to the

Securities Exchange Act of 1934. The custody of customers' securities and funds customarily accompanies the grant of discretionary power, and vice versa. Obviously, it cannot be said that as a general rule investment advisers are given to fraudulent practices. We say merely that ideal conditions for fraud exist in most cases. It needs but a few defalcations to cause great damage to investors. Here again, the amendments recommended in the Report would tend to prevent such defalcations. In this connection it may be noted that:

(1) About 258 registered investment advisers, according to their applications, accept or will accept discretionary accounts for their clients.

(2) About 128 firms accept or will accept custody of their clients' securities or funds for safekeeping or custody.

And with respect to the prohibitions contained in Section 206(3) concerning participation in transactions with or for customers in which the investment adviser has an adverse interest, it may be noted that:

(3) About 101 firms act or will act as principal in transactions of purchase and sale of securities in which their clients are selling or buying securities.

(4) About 167 firms act or will act as brokers in connection with the purchase and sale of securities for their clients' accounts.

(d) Section 208(c). This section makes it unlawful for any registered investment adviser to represent that he is an investment counsel, or to use the name "investment counsel" as descriptive of his business, unless he is primarily engaged in furnishing continuous investment advice on the basis of the individual needs of each client. The power to inspect books and records would aid the Commission in determining whether the statutory limitation was being observed. There are about 322 registered investment advisers whose registration applications state that they are performing the type of service which entitles them to represent that they are "investment counsel."