SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

SMALL ACCOUNT INVESTMENT MANAGEMENT SERVICES

Recommendations for Clearer Guidelines and Policies

Report of the Advisory Committee on Investment Management Services for Individual Investors

JANUARY 1973

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Advisory Committee on Investment Management
Services for Individual Investors

January 18, 1973

Honorable William J. Casey
Chairman
Securities and Exchange Commission
Washington, D.C. 20549

Re: Recommendations for Clearer Policies and Guidelines for Small Account Investment Management Services

Dear Chairman Casey:

The Advisory Committee is pleased to enclose its report on Investment Management Services for Individual Investors.

The Committee commenced its work on October 20, 1972, and, in accordance with its mandate, focused on small account investment management services. In this connection, the Committee recognizes the importance of the role of the small investor in the market place. Moreover, the Committee is mindful that in order to maintain the small investor's interest in direct stock ownership, he must be assured of a reasonable opportunity to invest with the benefit of the type of research and management available to large individual and institutional investors.

It appears that many smaller investors feel they need and are seeking in increasing numbers full-time, individual investment management. Traditionally, this kind of service has been available only to very affluent investors. However, in recent years, many investment advisers (and, in some cases, broker-dealers, banks and bank affiliates) have developed investment management services for smaller investors with as little as $5,000 to invest. The Committee agreed on $200,000 as the approximate upper limit of the small account service category.

As you pointed out in your statement announcing the establishment of the Committee, there is a great deal of uncertainty about the applicability of the federal securities laws--particularly the Investment Company Act and the Securities Act--to small account investment management services, which may have inhibited the promotion of individualized services and, in some cases, may have resulted in inadvertent violation of the federal securities laws. The Committee has made several recommendations which it believes will provide the Commission with a framework for developing clearer policies and guidelines with respect to such services. The Committee's major recommendations are briefly summarized as follows:

1. A small account investment management service should not be treated as an investment company for the purposes of the Investment Company Act whether or not it furnishes clients an individualized service, provided that there is no pooling of clients' accounts.

2. A small account investment management service should not be treated as making a public offering of a security for the purposes of the Securities Act, if it (a) furnishes clients an individualized service, or (b) makes only recommendations to clients and has no discretion in the execution of portfolio transactions of clients.

3. The Commission should adopt guidelines,as suggested by the Committee, for persons offering small account investment management services so they can determine whether they are offering an "individualized service."

4. Firms offering small account investment management services should be required, as a matter of Commission policy, to give prospective clients a written disclosure statement containing certain material information which will aid them in deciding whether to retain the services of a particular firm.

5. The Commission should adopt rules or publish interpretations to provide necessary protections for clients of small account services against the effects of certain conflicts of interests that might arise in connection with the operation of such services (e.g., conflicts arising from fee-sharing promotional arrangements, broker affiliations, and use of inside information).

6. The Commission should take appropriate action to institute (a) standards for professional qualifications and financial responsibility of investment advisers; and (b) a system of self-regulation of investment advisers.

The Committee believes that, if the Commission adopts and implements these recommendations, individualized small account investment management services would be encouraged in a manner consistent with the protection of investors.

The Committee wishes to express its appreciation to the Commission and its professional and secretarial staff for their exemplary cooperation in this undertaking. In this connection, the Committee wishes especially to thank Peter Sullivan, Attorney in the Office of Chief Counsel of the Division of Investment Management Regulation, for his outstanding contributions to the substantive tasks as well as his work as Secretary.

The Committee would be pleased to discuss its report with you, the other members of the Commission and its staff.

Sincerely,

Douglas D. Milne, Jr.

Douglas D. Milne, Jr., Chairman

Enclosure

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B. Securities Act Release No. 5325 (October 20, 1972), which announces the Committee's objectives and solicits public comments.

C. Litigation Release 4534 (February 6, 1970), which contains the Commission's complaint and the court's order in S.E.C. v. First National City Bank.

D. Sample Personal Data Questionnaire for Prospective Clients of a Small Account Investment Management Service.

E. Commission Staff Memorandum: **Investment Counsel and** the Investment Company and Investment Adviser Acts of 1940.

Summary of Recommendations (cont'd)

Summary of Recommendations (cont'd)

REPORT OF THE ADVISORY COMMITTEE ON INVESTMENT MANAGEMENT SERVICES FOR INDIVIDUAL INVESTORS

I. INTRODUCTION

On October 12, 1972, William J. Casey, Chairman of the Securities and Exchange Commission (the "Commission") announced the appointment of the Advisory Committee on Investment Management Services for Individual Investors. The Committee's general purpose is to assist the Commission in developing clearer policies and guidelines with respect to such services.1/ The Committee's work is part of a high priority Commission project of determining what can be done to assure that those members of the investing public, who prefer to invest in securities directly rather than through investment companies, can obtain the benefit of research and professional judgment. Chairman Casey has said that

> With the present capabilities of the computer, there should be no reason why individualized advisory services can't be developed for people with relatively small amounts to invest. These services could provide continuous account supervision and follow-up for significant numbers of direct investors and establish important new trends for the securities industry. Our present view is that these services could dramatically reduce the disparity between research information and investment management available to institutions and that available to individuals--and, to the extent these services close this gap--they should be encouraged. 2/

1/ Securities Act of 1933 Release No. 5321 (October 12, 1972), hereinafter referred to as "Release 33-5321." This release is attached as Appendix A.

2/ "Where are We Going?" Address by Chairman Casey before the Economic Club of Detroit (September 18, 1972), pp. 10-11.

Before such investment management services for smaller investors can be encouraged, several regulatory problems have to be resolved. In describing the Committee's assignment, Chairman Casey identified the general nature of these problems:

> [T]here is a great deal of uncertainty about the applicability of the Investment Company Act of 1940 and the Securities Act of 1933 in this area. An advisory service which makes large scale solicitations of relatively small accounts and provides substantially the same advice to clients can become functionally indistinguishable from an investment company. Representations as to "individualized" treatment of clients may in such a case also raise questions under the antifraud provisions of the Investment Advisers Act of 1940. On the other hand, notwithstanding some overlapping investment advice, such a service might actually provide individualized service. 3/

Chairman Casey also pointed out that the Commission is concerned that, in the absence of clear standards, some advisory firms may have been inhibited from establishing non-pooled, individualized advisory services, and that others may be inadvertently operating such services in a manner contrary to the federal securities laws.

The Committee held its first meeting on October 20, 1972, and its ninth and last meeting on January 4, 1973. At the first meeting, the Committee approved a memorandum of its objectives with a view toward publishing it and soliciting comments and suggestions of persons in the investment management business, members of the bar, and other interested persons. The Commission published this memorandum on

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3/ Release 33-5321

October 27, 1972.[4/] The Committee received 23 letters of comment which it has considered in formulating its recommendations.

Since the concept of an investment management service for small accounts is relatively new, the members of the Committee believed that it would be helpful to supplement their personal knowledge of this part of the investment advisory industry. Therefore, the Committee decided at its second meeting on November 2, 1972, to request that the Commission obtain some basic data on small account investment management services. The Committee approved a questionnaire form at its third meeting, November 9, 1972, and it was later approved by the Commission. The questionnaire was mailed on November 22, 1972 to about 130 registered investment advisers and broker-dealers, and to some banks which the members of the Committee, based on their wide knowledge of the industry, either knew were,or thought might be, providing small account services. The questionnaire was intended to elicit responses from firms which offer investment management services to small accounts (i.e., less than $200,000). In order to preserve the confidentiality of individual replies, Committee members other than Mr. Rosenblat have been given only general analysis and tabulations prepared by Mr. Rosenblat's office.

As of the time of the writing of this report, over 60 replies to the questionnaire have been received. About fifty of these stated that they are offering investment management services for small accounts, and 39 of these 50 have been analyzed. Although more replies are expected, in order to meet its deadline, the Committee has used the information tabulated and analyzed to date as a helpful

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4/ Securities Act of 1933 Release No. 5325 (October 27, 1972). This release is attached as Appendix B.

adjunct to the research and personal knowledge of Committee members. In the unlikely event that the data collected after the filing of this report compels any substantial changes in its conclusions, the Committee will so advise the Commission.

The main body of the report is divided into seven sections as follows:

Section II generally describes the current business practices of small account investment management services.

Section III discusses the applicability of the Investment Company Act and the Securities Act to such services. In this regard, the Committee recommends that such a service not be treated as an investment company, whether or not it furnishes individualized treatment, provided that there is no pooling of clients' accounts. The Committee also recommends that such a service should not be treated as making a public offering of a security if it (a) furnishes clients individualized treatment, or (b) makes only recommendations to clients and has no discretion in the execution of portfolio transactions of clients.

Section IV sets forth the Committee's guidelines for determining whether "individualized service" is rendered by an investment management arrangement. This section also proposes guidelines for disclosure by firms offering small account investment management services.

Section V discusses certain conflicts of interest and other investor protection problems that arise in connection with the operation of small account investment management services. This section also sets forth recommendations as to what specific remedial actions the Commission might take.

Section VI discusses the applicability of the Investment Advisers Act of 1940 to broker-dealers who operate small account services and receive compensation only in the form of brokerage commissions.

Section VII discusses the applicability of the Committee's recommendations to small account services operated by banks.

Section VIII sets forth the Committee's recommendations relating to the need for (a) standards for professional qualifications and financial responsibility of investment advisers and (b) self-regulation of investment advisers.

II. INVESTMENT MANAGEMENT SERVICES FOR SMALL ACCOUNTS - CURRENT BUSINESS PRACTICES

Despite concern about the unprofitability of individual investment management for small investors and the expense of the service to investors, the number of investment advisers and broker-dealers offering such a service appears to be increasing. Among the factors that may account for this increase, one is probably the increase in affluence among individuals and the accompanying tendency on the part of many to think in terms of individual management for their money -- which entails more service than securities brokers have generally been equipped or willing to provide out of only their commission income. A second factor may be the apparent disenchantment (which may be only temporary) with mutual funds,perhaps resulting in part from certain well-publicized shareholders' suits against fund managers and a few spectacular failures of performance.

Whatever the reasons, a new type of service appears to be developing for the small investor. The service takes many forms, but all may appropriately be referred to collectively as "small account investment management services". These accounts are "small" only in relation to the size of accounts to which individual investment supervision has been heretofore available and may range as low as a few thousand dollars and as high as $200,000. The services offered provide for investment of the client's funds and continuous management on a non-discretionary as well as a discretionary basis.

In services operated on a discretionary basis the investment manager has the power to effect changes in the client's investments without obtaining his prior approval. Investment advisory services which merely give advice as to the investment quality or characteristics of particular securities, as for example, **market** newsletters, are not covered by this report.

There are three general classes of persons who operate small account investment management services:

(1) Investment advisers registered under the Investment Advisers Act of 1940. Some of such investment advisers are also broker-dealers registered under the Securities Exchange Act of 1934 or are affiliated with such broker-dealers.

(2) Broker-dealers registered under the Securities Exchange Act of 1934 who provide an investment management service through managed discretionary accounts. Such a broker-dealer receives only brokerage commissions. At the present time, there appear to be only a very few firms in this category, at least one of which is also a registered investment adviser.

(3) Banks which are exempt from registration under the Advisers Act and the Exchange Act. Only a few banks are presently providing such services, which they typically operate on a non-discretionary basis. However, the Committee believes that other banks may be planning to enter this field. In this connection, it may be noted that many many bank holding companies are in the process of organizing investment advisory subsidiaries. Since there is no specific exemption from registration under the Advisers Act for these subsidiaries, several of them have registered.

The various characteristics of small account investment management services, as understood by the Committee on the basis of its information to date, are as follows:

(1) These services generally purport, explicitly or impliedly, to provide enough individual attention and selectivity of investments so as to make them distinguishable from mutual funds and other investment companies. However, it is apparent that while some of the services do provide an extensive degree of individualization, it is difficult to discern in some of the services any real advantage, in terms of cost, over investment in a mutual fund, particularly the no-load variety.

(2) An effort is made to minimize direct individual communication which is commonly referred to as "hand holding". Thus, most services require that the investment manager be given discretion in the selection of securities for the account, although several will accept

specific portfolio instructions from clients under certain circumstances. At least one service that accepts non-discretionary accounts charges a higher fee to compensate for what it considers the added burdens. However, the client's needs and objectives are considered in varying degrees from service to service, but often an effort is made to confine client contacts, usually to the mails or the telephone. In larger operations, such contacts, to the extent possible, are handled by administrative personnel rather than portfolio managers.

(3) Client investment objectives are usually constrained. Some services accept only clients whose objective is long-term growth of principal. However, most accept clients whose objective is growth of principal, income or a balance between income and growth.

(4) Some services select brokers through whom business is transacted. However, most services permit the client to select his own broker. In this regard, most services have no affiliations with broker-dealers. Certain of the firms offering such services are subsidiaries of major national brokerage firms or are registered themselves as broker-dealers and derive substantial business from referrals by the registered representatives associated with them or their parents, although they do not necessarily restrict their clientele to their or their parents' brokerage customers.

Since a number of these services utilize the custodial, record keeping and reporting facilities of the referring broker, there need not necessarily be an affiliation between the brokerage firm and the advisory firm. Frequently, an important element of such relationships is that the adviser communicates to the greatest extent possible with the client through the broker, thus isolating the adviser to a great extent from the "hand holding" functions which are generally thought to be time consuming, non-productive, and inefficient. This makes it possible for the broker to solidify his relationship with the client through greater personal contact than might otherwise be possible. In these cases the account brokerage is generally transacted through the client's broker which facilitates the record keeping function.

Some advisory firms which have no ownership affiliation with a brokerage firm, require all accounts to be maintained with a single brokerage firm or with one of a limited number of specified firms. This is done primarily to coordinate the record keeping functions performed by that brokerage firm for the advisory clients. However, because each account is separately maintained, it is not currently possible for these clients to derive any of the possible benefits of bunching.

(5) Most services require the client's stock certificates to be left with a custodian in nominee name or with a broker in "street" name. Some services designate a specific custodian or broker whose services are required to be used. Investment advisers rarely maintain

custody of clients' funds or securities.

(6) Some services refer to a model account in making investment decisions, but few admit to strict adherence to a predetermined portfolio structure for all clients. Most services utilize approved lists of securities. One uses the Standard & Poor 500; another has a list of more than 200 securities. Others are more limited. While in many of the services there may be a number of securities common to the accounts of most if not all clients, it generally appears that these securities are purchased at different times, in varying percentages of the total account value and have different tax cost bases.

(7) Most of the services have some sort of client screening process,usually in the form of a questionnaire or profile data sheet to elicit a variety of information from the potential client. Some of the services will not accept a client until all parts of the questionnaire have been completed. Other services only request the information; a few services do not require or even request any information. Most services which obtain information from prospective clients use it as a basis from which the suitability or appropriateness of the service for the prospect may be evaluated and for developing an investment program consistent with the client's needs and objectives. Beyond this, certain of the data might influence individual investment decisions, as, for example, through an analysis of the tax consequences to the investor.

(8) Most of the larger services appear to make extensive use of the computer not only in maintaining records of the client and in providing him with reports, but in the internal processes that lead to the individual investment decisions. Many of the services rely heavily on the client's own brokers to provide, not only custody, but much of the record keeping and to provide the client with a confirmation of each transaction and possibly monthly or quarterly account statements. In some cases the service may provide the client with an annual or semi-annual appraisal and/or analysis.

(9) Most of the services provide for a minimum initial account size, but this varies from $1,000 at the one extreme to $100,000 at the other. An analysis of the first 39 returns on our questionnaire shows that 2 respondents had a minimum account size of $100,000 or more; 2 respondents had a minimum account size of $50,000 to $100,000; 7 respondents had a minimum account size of $20,000 to $50,000; 17 respondents had a minimum account size of $5,000 to $10,000; 4 respondents had a minimum account size of $1,000 to $5,000; and 7 said they had no minimum account size, although 2 of these 7 suggested $10,000 to their clients as a minimum. Those firms that provide a more conventional separate counseling service for larger accounts usually provide a maximum size for accounts in the small account category. Five hundred thousand dollars is the highest stated maximum for a service which handled small accounts (i.e., under $200,000). Most services will not continue an account if

withdrawals cause the account to be reduced below the required minimum. Certain services will permit separate accounts of spouses or parent and child to be aggregated to meet the minimum, but most require the minimum to be met for each account.

(10) The written materials describing the various services vary greatly in the extent and nature of information disclosed about the actual operation of the services described. Most are more promotional than informative. Some make no reference to performance records of the service, in others such references are vague or incomplete; some such references may be misleading. From most of the literature it is impossible to ascertain the identity or the professional competence of those who are responsible for the investment decisions. The written contracts that are required to be executed by the clients as a prerequisite to receiving the service are in many cases simply a promise by the client to pay fees at a stated rate. Little, if anything, is said in many of such contracts of the nature of the service that is to be performed as consideration for such fees. The description of the nature and extent of the service offered is usually contained in a brochure.

(11) Most services provide for review of accounts on a continuous or periodic basis, usually by an account manager. Certain services indicate that they perform some sort of review each time assets are added or withdrawn. Most indicate they are equipped to

take some action should circumstances affecting a particular security warrant action in the interim between regularly scheduled account reviews. All services indicate that the securities in each account are reviewed for quality and other factors. The emphasis placed by the firms on the review of the individual needs of the client varies widely.

(12) About half of the 39 firms surveyed said they relied almost exclusively on in-house research. Only three firms said they relied on outside sources for substantially all of their research. A little less than half relied on a combination of the two. The number of securities followed by the firms varied from 15 to 25 to about 1400. The number of security issuers usually approved for purchase varied from a low of 5 to 8 to a high of 700 to 800.

(13) Most firms say they do not, as principal, sell securities to or buy securities from clients, nor do their affiliates. The exceptions appear where the service is operated by a broker-dealer or by an adviser who is also a broker-dealer. Some of these services stated that they may sell as principal to a client in connection with an underwriting or as a market maker, but all stated that full disclosure is made of these transactions.

Most firms said that they and their affiliates do not sell securities to or buy securities from clients, when acting as agent or broker for some one other than the client. Again, there were some exceptions in the case of certain firms which were brokers or broker affiliates. These firms indicated that these types of transactions occur in rare situations where, for example, they act as a market maker. These firms indicated that these transactions were disclosed to clients.

Several firms stated that they or their affiliates will recommend the purchase or sale of securities in which they or their affiliates have a position or interest. Most of these firms stated that they imposed restrictions on transactions for their own and their affiliates' accounts. However, these restrictions varied extensively from very specific self-imposed rules and codes of ethics to mere disclosure.

III. INVESTMENT MANAGEMENT SERVICES AND THE INVESTMENT COMPANY ACT OF 1940 AND THE SECURITIES ACT OF 1933

In February of 1970, the Commission brought injunctive proceedings against First National City Bank and Merrill Lynch, Pierce, Fenner and Smith, Inc. ("Merrill Lynch"), alleging a violation of the registration requirements of the Investment Company Act of 1940 in the operation of a Special Investment Advisory Service ("SIAS"). The essential features of SIAS were (a) a limited power of attorney running from the customer to the bank coupled with an authority to the broker to accept instructions from the bank with respect to the customer's account with the broker, (b) a deposit of at least $25,000 for the purchase of securities pursuant to the instructions of the bank, (c) instructions by the bank to invest each account in seven or eight securities, the selection of securities being the same for new accounts invested at any given time, depending upon whether the customer's objective was current income or long-term capital appreciation, and (d) handling the account otherwise as a normal brokerage account with record keeping and reporting, including advices and confirmations to the customer, conducted as in any other customer's securities account in the custody of the broker. Although it is not clear to what extent "bunching" of orders for concurrent purchases and sales of the same security for independent accounts occurred, there was no pooling of accounts in the conventional sense, the usual segregation requirements being met and each individual having the right to close his account at any time and receive specific securities in specific amounts that have been carried for his account. The Commission complaint emphasized the active advertising of the SIAS and the alleged assurance given investors in the SIAS that their investments would receive the same individualized attention and supervision provided to bank customers with managing agency accounts of $200,000 or more. However, the Commission complaint made no formal allegation that the bank's representations as to the individual nature of the attention given by the service were misleading or fraudulent.

The Commission alleged that participations in the arrangement were securities, as defined in Section 2(1) of the Securities Act, in the form of a power of attorney permitting the bank to trade for the investor's account through the broker. Apparently, the Commission considered the discretionary trading authorizations to be investment contracts or participations in profit-sharing agreements.

To some, a novel concept embodied in the Commission's complaint was the treatment of SIAS as an entity. Not only was SIAS alleged to be an "investment company" (a term which under Investment Company Act Sections 2(a)(8) and 3(a)(1) could include "any organized group of persons whether incorporated or not" which "is . . . engaged primarily in the business of investing . . . in securities"), but it was also treated as the "issuer" of securities for purposes of the Securities Act and was even made a juridical person by being named as a defendant in the complaint. While this may have been necessary in order to avoid the exemptions from the Investment Company Act and the Securities Act for a bank and securities issued or guaranteed by a bank,[5/] the complaint still stands as the Commission's position.

The controversy involving the SIAS was resolved by a stipulation and a consent order of the District Court which effected the discontinuance of the SIAS, but authorized a service for small investors (i.e., those whose investment accounts are not large enough to warrant the bank furnishing investment advice on an individual basis) similar to SIAS, except that the bank was to be given no discretion in portfolio transactions but would make recommendations to each individual customer and that the number of brokers among which the customer could select for the carrying of his account was increased from one to three or more.[6/]

As interpreted by the Commission staff in subsequent responses to requests for no-action letters, the critical elements necessary to avoid the registration requirements of the Investment Company and Securities Acts in the offering of investment management services to the small investor are as follows:

(1) If the adviser is given discretion so that it may place orders for the account or give instructions for transactions in the account, the advisory service must be "individualized."

5/ See Section 3(a)(2) of the Securities Act and Section 3(c)(3) of the Investment Company Act. Cf., Prudential Ins. Co. v. S.E.C. 326 F.2d 383 (2 Cir. 1964), cert. den., 377 U.S. 953 (1964); in which the Commission successfully argued that a "separate account" of an insurance company excepted from the definition of investment company in the Investment Company Act was nevertheless a separate, non-excepted investment company.

6/ The Commission's complaint and the court's order in the SIAS case is contained in the Commission's Litigation Release No. 4534 (February 6, 1970), which is attached as Appendix C.

(2) If substantially the same or substantially overlapping investment advice is rendered to each account or to a discernible group or groups of accounts and such accounts engage in the same securities transactions, the accounts may not be the subject of discretionary trading authorization.

(3) Accounts will be treated as discretionary for purposes of determining the applicability of the registration requirements, even if discretionary authority is not given by the customer so long as the customer is given to understand that only through consistently following the adviser's advice will his objective be met or his business welcome or, without such efforts to discourage the exercise of his independent judgment, the customer in fact slavishly follows the adviser's recommendations.

(4) Mass merchandising of discretionary accounts of relatively small size, through advertising in the mass media or similar promotional efforts, was viewed with skepticism by the staff which believed that such activities would probably be inconsistent with individualized investment advice and services.

These past Commission and staff positions outlined above have not taken into account some substantial distinctions between accounts such as those operated by First National City Bank and Merrill Lynch in the SIAS case and pooled accounts such as mutual funds. Also, because these positions have not recognized the way in which many portfolio managers operate, if taken literally, they could needlessly cast doubt on the hitherto unregistered offering of discretionary investment management for large accounts.

Except for the use of "street names," individual discretionary investment accounts do not involve pooling or commingling of the customers' investments with those of other customers. Thus, unlike mutual funds or the other usual types of registered investment companies, the customer continues to own his own securities without the intervention of an entity in which he has shares. Accordingly, he can deal independently at any time with those securities, sell them, pledge them, exchange them or repossess them, and the income tax cost of the securities is based on the cost of the securities to him. Moreover, he receives information directly and immediately on changes in his investments. This is markedly different from shares purchased in a mutual fund with an accumulation of unrealized capital gains; the mutual fund shareholder has a tax basis for his shares which includes the unrealized capital gain and yet he pays a tax if he continues to hold the shares after any of the unrealized gain has been realized. The mutual fund shares represent only an undivided interest in a portfolio of securities rather than direct ownership of specified securities.

The emphasis on giving different customers different investment advice in order to avoid registration seems exaggerated in view of the way in which many portfolio managers operate. If two customers with identical investment objectives and substantially the same needs bring the same amount of cash to the portfolio manager for investment, their funds would be invested in the same securities, unless either the operation of the adviser is decentralized so that the adviser has no consistent advice to give as an institution or the adviser is deliberately avoiding a concurrence among the securities in customers' accounts because he is fearful of the attitude of the Commission and its staff as expressed in the recent responses to no-action requests referred to above. Many portfolio managers, even those for large institutions, determine as of any given moment upon the same securities to be recommended to customers having the same objectives. This approach should not be discouraged since in this way each customer gets the best advice which the investmant manager has to offer. If "overlapping" investment advice is to be permissible for large accounts, as the Committee believes it should be, it is a mistake to make the practice impermissible or to discourage it merely because the accounts are small. We believe that mere overlapping of investment advice should not determine whether or not an investment company has been formed.

It is true that, in many respects, a small account investment management service operated on a discretionary basis can be the functional equivalent of an investment company if clients receive substantially overlapping advice. Moreover, it is true that many of the dangers with which the Investment Company Act is designed to deal may exist in an investment management service. However, functional equivalence to an investment company and common need for investor protections do not necessarily create an investment company. As indicated above, the Committee believes that, with rare exceptions, there is usually no investment company formed when an investment adviser provides common investment management services on a non-pooled basis. This would be the case when the relationship is directly between the investment manager and client, with each client having his own account, receiving confirmations after every transaction, and otherwise having complete ownership and control over the securities in his account.

Therefore, although the Committee recognizes that there are some very significant investor protection problems raised by investment management services it does not believe that these problems should be remedied by imposing the pattern of regulation of the Investment Company Act on such services. Rather, the Committee believes that these problems can be dealt with by appropriate disclosure and other guidelines and, where necessary, rules and regulations under the Investment Advisers Act of 1940. The Committee's recommendations in these matters are discussed in the following, and in Sections IV and V of the report.

Apart from the Investment Company Act question, the Committee believes that, under certain circumstances, the promotion and operation of an investment advisory service may involve a public offering of securities in the form of discretionary accounts. An investment service which is operated on a discretionary basis and does not afford investors individual attention would appear to be offering an investment contract or security, and if substantially the same investment advice is given to all clients or to discernable groups of clients, and clients are generally solicited, there could be a public offering of one or more investment contracts or securities which should be registered under the Securities Act.

A service which purports to furnish investment management but does not tailor the advice given to the particular needs of the client creates an impersonal relationship. The fortunes of the client depend on no factors other than the ability of the investment adviser to make a profit. The client stands in substantially the same position as other clients. Such an arrangement is basically an investment in a common enterprise for profit. The person offering such a service is acting as a promoter of discretionary accounts. That situation is in stark contrast to the confidential professional relationship between the investment manager and the client where the manager is furnishing investment advice on the basis of the individual needs of each client. If such an investment manager manages clients' funds on a discretionary basis, each discretionary account of each client may be considered an investment contract. 7/ However, no public offering should be deemed to be made of such a contract if each one is essentially different or individualized. In Part A of Section IV of the report, the Committee has set forth what it considers to be the elements of an individualized investment management service.

In actual practice the distinction between individual and non-individual treatment may be difficult to draw. But the Committee believes that it is a valid and salutary one, and a logical extension of the private offering exemption under Section 4(2) of the Securities Act. Cast in those terms, a client of an investment manager who receives the full complement of fiduciary attention and protection does not need the protection of a Securities Act prospectus. Any material information about the investment manager and his services should naturally flow from the relationship. However, where a person offers investment advice of an impersonal or general character to clients on a discretionary basis,

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7/ Discretionary commodity trading accounts have been held to be securities in antifraud actions under federal securities laws. See Johnson v. Espey, CCH Fed. Sec. L. Rep. ¶ 93,376 (SDNY 1972); Berman v. Orimex Trading, 391 F. Supp. 701 (SDNY 1968); Maheu v. Reynolds & Co., 282 F. Supp. 423 (SDNY 1967). Cf. Bache & Co. v. Commercial Iron & Metal (1970-71 Transfer Binder) CCH Fed. Sec. L. Rep. ¶ 93,114 (SDNY 1971). In an action alleging violation of the registration requirements of Section 5 of the Securities Act, a court held that a discretionary commodity trading account was a separate agency agreement and thus not publicly offered. Milnarik v. M-S Commodities, 320 F. Supp. 1149 (N.D. Ill. 1970); affirmed on appeal, but on ground that the discretionary commodity trading account was not a security. Milnarik v. M-S Commodities, 457 F.2d 274 (7 Cir. 1972); cert. den., 93 Sup. Ct. 113 (1972).

the investor will not receive all of the benefits that usually attend a professional or fiduciary relationship, and thus should have all of the risks and other material information spelled out in a prospectus.

On the other hand, the Committee does not believe the Securities Act should apply to a person who offers an impersonal investment service on a non-discretionary basis. Since the investor in each instance is free to accept or reject a specific recommendation, it would be difficult to find a security under present interpretations of the Securities Act. However, the investor must be in a position to truly exercise a judgment with respect to each and every recommendation. The Committee believes that the procedure specified by the court's order settling the Commission action against First National City Bank's SIAS provides an appropriate model for a truly non-discretionary service; i.e., the person furnishing the investment advice should send any recommendations to the client by mail and any client deciding to act upon such recommendation could transmit the order to buy or sell securities to a broker-dealer. Although the settlement order appears to require that the client transmit the order directly to a broker, the Committee does not see any reason why any distinction should be drawn where the order is transmitted to the person furnishing the advice who in turn sees that the order is executed.

In order to provide assurance that clients of small account investment management services, which are not subject to the registration requirements of the Securities Act, receive adequate information concerning such services, the Committee has set forth in Section IV what it considers to be reasonable disclosure guidelines for offering such services.

IV. GUIDELINES FOR SMALL ACCOUNT INVESTMENT MANAGERS

A. Individualized Service

In Section III of the report, the Committee stated that the presence or absence of individualized service is a factor in determining whether the offering to the public of an investment management service operated on a discretionary basis, should be considered a public offering of securities for the purposes of the registration requirements of the Securities Act. In this regard, the Committee recommends that the Commission publish guidelines which firms offering investment management services could follow in order to assure themselves that they are furnishing clients individualized service or treatment and thereby avoid any possibility of having to comply with the registration requirements of the Securities Act. The Committee believes that the following discussion should assist the Commission in developing such guidelines.

An investment manager should make reasonable efforts to obtain financial and other personal information concerning prospective clients. This information should be used first to determine whether the service offered is suitable for the particular investor. Basically, this information should cover such factors as the nature and amounts of the prospective client's assets, investments and insurance, and the nature and extent of his personal and family obligations. Appendix D to the report contains a sample personal data questionnaire, similar to those used by some investment managers. The Committee believes that this sample would serve as a guide in determining the types of information that would be useful to the investment manager. The investment manager must stand ready to execute his fiduciary duty and refuse to accept a prospect's account if, for example, the minimum fee for the service would be too high for the prospect under the circumstances or if the prospect requires greater protection of capital than he could be afforded under the service.

After making the initial decision to accept the prospect's account, the information received should be used to determine the client's general investment objectives and personal requirements, and the methods appropriate to their attainment.

After setting the general parameters for the managment of a client's funds, the investment manager should make a reasonable effort to obtain up-dates of this information from each client, not less than annually. Clients should also be encouraged to update this information voluntarily (for example, toward the end of the tax year or when material changes occur in financial condition or personal situation).

In the event a prospective client refuses to disclose certain information about himself this should be taken into consideration by the investment manager in determining whether it will be possible for him to furnish such a person individual treatment, and thus whether he should take on that person's account. In some cases, the prospect's failure or refusal to disclose information may be material enough to warrant turning down the account. Moreover, in most cases it would not be sufficient for an investment manager to know merely the prospective client's investment objectives and willingness to accept risks. As a professional, the investment manager must be in a position to exercise an independent judgement with respect to the client's needs and objectives.8/

Another element of individualized treatment is affording clients a reasonable opportunity to exclude specific categories of securities within reasonably defined limits. For example, for one reason or another, a client may not want to invest in securities of liquor, tobacco or pharmaceutical companies.

Continuous monitoring of the securities issues held by clients does not in itself denote individual treatment. This is basically a research function. However, individual treatment does require that reviews of the account of each client be conducted as frequently as research and the objectives and needs of the client dictate. Several events should trigger a review of individual accounts. For example, an unfavorable research report on a security issue should cause the investment manager to review the portfolio of all clients with that issue. A favorable report on a security issue might cause the investment manager to review clients' accounts to determine which may have buying power. A change in a client's financial status or personal circumstances should result in an overall review of the client's account and needs.

8/ The confidential relationship existing between investment managers subject to the Advisers Act and their clients is given explicit recognition by Section 210(c) of that Act, which provides that "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 or investigation having as its object the enforcement of a provision or provisions of this title."

In order to maintain the personalized nature of the relationship, the investment manager should provide the client reasonable access to information on the status of his account and should be willing to answer questions relative to his account. This does not necessarily mean that an account manager of the investment manager must be available at all times by telephone or in person. Individualized treatment does not necessarily require continuous "hand holding", but it does require a reasonable opportunity for the client to communicate with the investment manager. In some larger investment management operations, account managers may handle several hundred clients. As a consequence, the investment manager has responsible administrative personnel who can handle the day-to-day communications with clients and if necessary they consult with the account manager, which relieves the account manager of a substantial burden. This method of operation is consistent with giving individaalized service.

The use of a model portfolio or account by an investment manager is not necessarily inconsistent with the rendering of individual treatment, if it is used only as a guide for selecting securities for clients, and investment decisions on behalf of clients are not made in a mechancial manner in reference to the model. In this connection, an investment manager may be able to program a computer to take into account all of the characteristics of clients and reduce such characteristics to several categories, with certain programmed exceptions, devise model portfolios for each of those categories, and then make investment decisions at the push of the button in relation to the model portfolios. However, in view of the number of variables involved in investment management, and of the present state of computer art, there is still a need for the element of human judgement.

The Committee considered devising some ratio of accounts to account managers above which it would be deemed impossible to provide individual treatment. However, the Committee did not believe it was practicable to develop any reasonable numerical test in this regard. The ability of an account manager to handle a large number of accounts depends upon a number of factors; for example, the extent to which record keeping is computerized, the number of administrative and support personnel, not to mention the account manager's physical stamina and mental acumen. The ability of an account manager to handle large numbers of accounts may also depend on the type of accounts for which he is responsible. For example, if he handles only accounts for clients whose objective is long-term oriented, there is less need for day-to-day review, thus permitting a higher ratio of accounts to managers without necessarily risking loss of individual treatment. On the other hand, the Committee does not believe that trading accounts lend themselves to individual treatment unless there is a substantially smaller ratio of accounts to account managers in order to permit the necessary day-to-day review of accounts.

The Committee believes that the receipt by the client of a confirmation after every transaction is a sine qua non of individual treatment. So too is the maintenance of a completely separate account for each client and the retention by each client of all the attributes of ownership of the securities in his account, including voting rights, the right to withdraw his certificates, and the right to terminate participation in the service at any time. However, it would not be inconsistent with the rendering of individual treatment for the investment manager to combine or bunch orders for the purchase or sale of securities for clients in order to obtain best execution. This assumes, of course, that each client receives a confirmation and owns specified whole shares after consummation of the transaction.

Finally, the Committee believes that in the process of rendering individualized service, quite frequently, an investment manager may make *bona fide* decisions to purchase the same security for all or a large number of accounts. Assuming that these decisions are based on the requirements or objectives of individual clients, however many, as opposed to a non-discriminating, across-the-board technique, the Committee does not believe that portfolio similarities are inconsistent with the rendering of individual treatment. Most investment managers who have operated individualized services over a substantial period of time reported that their clients' portfolios tended to become more disparate with the passage of time. The Committee believes that over a period of time the interplay between personal factors (e.g., changes in financial status, tax considerations and the selection of securities) will generally result in greater variation in portfolios of clients whose accounts came under management about the same time.

The Committee believes that the foregoing would also be useful to the Commission in establishing guidelines on what constitutes "investment supervisory services," which is defined by Section 202(a)(13) of the Investment Advisers Act. In this connection, see the Committee's recommendation in Part I of Section V of the report which deals with problems arising from use of the term "investment manager".

B. Disclosure and Advertising

Most persons offering investment management services distribute brochures or other written literature explaining the operation of their service. However, this material is often promotional in nature and frequently does not contain information an investor may consider material to his decision on whether to obtain the services of a particular manager. For example, many firms do not disclose the qualifications of the principals of the firm or of the firm's account managers and research personnel, although this information must be furnished in the Form ADV for registration under the Investment Advisers Act. The Committee believes that there is room for improvement.

Firms offering investment management services, of course, are basically selling a service. However, as noted on page 24, the Commission could well take the position that even an individualized small account service offers each respective client an "investment contract" within the meaning of the definition of the term "security" contained in both the Securities Act of 1933 and the Securities Exchange Act of 1934. At least until the question is resolved, there would seem to be enough of an argument for this position so that persons offering such services would for the most part take refuge in compliance with such restrictions and other requirements as the Commission might wish to impose as a condition for not taking injunctive or punitive action, assuming, of course, that such requirements are reasonable and not so onerous as to destroy the economic feasibility of such services. Without, therefore, deciding the issue as to whether a "security" has been offered or sold or whether, assuming it has been offered or sold, it has been offered publicly, the

Commission should adopt a statement policy on sales literature for small account investment management services, citing, if it wishes: Section 10(b) under the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, which prohibit fraud and deceptive acts in connection with the purchase or sale of a security; Section 15(c)(1) of the Exchange Act and the rules thereunder prohibit fraudulent and deceptive practices in connection with a person's business as a broker-dealer; and Section 206(4) of the Investment Advisers Act prohibits such practices in connection with a person's business as an investment adviser.

In addition, the Committee believes that the proposed statement of policy should apply to investment management services operated on a non-discretionary basis. Although in Section III of the report the Committee recommended that such services not be subject to the Securities Act, these services are rendered in connection with the purchase and sale of securities. For that reason, the statutory provisions cited in the previous paragraph also would appear to give the Commission an adequate basis to include non-discretionary services within the scope of the recommended statement of policy.

Therefore, assuming that the operation of an investment management service does not require compliance with the registration provisions of the Securities Act of 1933, the Committee recommends that persons offering such a service be required, as a matter of Commission policy, to furnish prospective clients, in writing, certain material information, which is set forth below:

1. A statement of the range of services offered, investment philosophy, and any special investment techniques of the firm.

2. A statement on the method of supervising accounts (including the method of recordkeeping), the personnel structure of the firm (including qualifications of account managers and research and supervisory personnel).

3. A statement on the sources of the firm's research and how the research is applied to the accounts.

4. A statement of the extent of the authority which the firm may exercise over investments of the clients (e.g., discretionary or non-discretionary) and of the extent of control which the client retains.

5. A statement (i) on the custody of the client's securities and cash, (ii) how brokers are selected or designated and (iii) how brokerage orders are placed.

6. A statement of the frequency and nature of (i) the review of client's accounts and of his financial situation and other personal circumstances, and (ii) any reports furnished to clients.

7. A statement relating to any services provided by the firm to clients other than small account service clients (e.g., mutual funds, pension funds, large individual accounts).

8. A statement on any possible conflicts of interests and the steps taken to avoid or minimize the adverse effect of such conflicts, including those discussed in the Section V of the report.

The Committee recommends that the Commission require firms offering small account investment management services to file with the SEC copies of their sales literature and the forms of their agreements. It is not the Committee's intention that the Commission staff review or comment on these filings in the manner that prospectuses are reviewed. Rather, the Committee believes this material would assist the Commission's inspection program and be of use to the members of the general public. Also, the requirement to file will help to assure compliance with the spirit of these guidelines.

The Committee also recommends that firms operating small account investment management services furnish clients reports at least annually showing the status of their accounts. Such reports should include, at least for discretionary accounts, the cost and current market value of each security presently held by each client. If any statement is furnished to clients or to prospective clients which purports to show comparative performance, then the Committee believes the comparison should be made only to a recognized and appropriate securities index or indices.

Related to the area of comparisons is the advertising by investment managers of the performance results of accounts under management. Rule 206(4)-1 under the Investment Advisers Act presently prescribes standards for advertising an investment adviser's specific past recommendations which may have been profitable to a particular client. The rule requires that advertisements by the investment adviser must set out, or offer to furnish, a list of all specific recommendations in the past year including the price of the particular securities recommended at the time of the recommendation and their present value.

Rule 206(4)-1 appears to be directed primarily at the advertisements of advisory services which provide advice through market letters, rather than at advertisements of investment management services. Thus, it is not clear whether the rule presently prohibits an investment manager from illustrating aggregate performance results on all accounts under management. In any case some investment managers use such aggregate performance figures which are similar to the performance charts of registered investment companies. It is the Committee's understanding that with the advice of counsel, some advisers have construed the rule as not applying to them. In this connection, the Committee believes that if the rule were interpreted to apply to such charts it would be impossible to make any such presentation. In its comment letter, the National Association of Securities Dealers ("NASD") appears to treat Rule 206(4)-1 as not applying to such illustrations, indicating that there are no standards to assure fair presentations of aggregate performance of accounts in an investment management service. The NASD also stated that "we recognized that there are difficulties in determining the proper criteria for such an illustration and the specifics of such a standard could not be determined without an in-depth study. Perhaps such a study is not even feasible, however, we feel that an attempt should be made to develop a method for advisers to publish their results in a way that is meaningful and informative to the public and is fair and consistent with their format." 9/ The Committee concurs with the NASD's recommendation. However, we recommend against *requiring* that small account managers make performance comparisons available.

9/ Letter from Gordon S. Macklin, President, NASD, December 5, 1972.

In addition, the Committee recommends that the Commission develop guidelines for making fair presentations of the performance of particular accounts. In this regard, the Committee believes that it would be reasonable to require that an investment manager who cites the performance of a particular account or accounts show the record of his worst performing account and make appropriate cautionary qualifications about what conclusions may be drawn from such a presentation.

V. CONFLICTS OF INTEREST AND OTHER INVESTOR PROTECTION PROBLEMS IN CONNECTION WITH THE OPERATION OF SMALL ACCOUNT INVESTMENT MANAGEMENT SERVICES

As was indicated in Section III of the report, a small account investment management service, whether it is operated on a discretionary or non-discretionary basis, can involve serious conflicts of interests and other problems which require some form of investor protection. In the following, the Committee has identified some of these problem areas and has made recommendations as to what specific remedial actions the Commission might take.

A. Fee Sharing and the Promotion of a Small Account Service

The Committee is concerned about the possible conflict of interest that may be involved if a broker-dealer receives compensation for referring clients to an investment adviser, whether such compensation takes the form of brokerage from unrelated accounts or of sharing of the adviser's management fee.

At the present time most small account services are operated by firms which are registered only as investment advisers. These advisers stress their freedom from affiliations with brokers, which they maintain permits them to render unbiased advice. These advisers do their own marketing, usually by advertising. Many of them receive referrals from brokers, but usually say that they do not compensate the brokers through fee sharing or unrelated brokerage. In this connection, many of these advisers permit the client to choose his own broker and the brokerage commissions anticipated by the broker are usually incentive enough to cause him to make a referral.

While that may be the general pattern in the industry today, there is every reason to believe that, to the extent Commission policy might encourage the expansion of investment management services, there will be a strong impetus to find new ways to market them. One indication of the possible future trends of this industry was a request for a Commission staff no-action letter on behalf of an arrangement in which a broker-dealer would receive a continuing fee from an investment adviser, as well as act as broker for the clients and have discretionary authority to execute the adviser's recommendations.[10/] In its reply, the Commission staff said, among other things, that because of its receipt of a portion of the advisory fees, the participating broker-dealer has "the incentive not to recommend to the customer any other investment adviser who might afford a superior service at an equal or a lesser cost." Furthermore, the staff said that the intermediation of the broker-dealer between the investment adviser and the client "may serve to obscure the legal and fiduciary responsibilities" which both the adviser and broker have to the client. The staff concluded that these factors combined to create a "course of business which would operate as a fraud or deceit upon any customer or prospective customer," that "it is not possible to provide disclosure

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10/ See Argus Securities Management Corporation, available June 1, 1971, CCH Securities Law Rep. ¶ 78,366.

to a client which could be meaningful," and thus ". . . disclosure cannot cure the inherently fraudulent aspects" of the proposal.

Although the Committee has difficulty with the staff's conclusion in that letter that something can be fully disclosed and still constitute a fraud, it believes that the staff correctly diagnosed the arrangement as containing inherent conflicts of interest. Although disclosure may provide some measure of protection to investors, the Committee does not believe any Commission policy should sanction arrangements which are so clearly inconsistent with the fiduciary obligations of brokers and advisers. In a somewhat similar situation, the Commission has recognized that an investment adviser to a registered investment company is acting inconsistently with its fiduciary obligations when it directs the investment company's portfolio transactions to broker-dealers as additional compensation for the sale of the investment company's shares. 11/

11/ See Statement of Policy on the Future Structure of the Securities Markets, February 2, 1972.

Therefore, the Committee recommends that the Commission, by appropriate rules, or through the National Association of Securities Dealers, (1) prohibit a broker-dealer from receiving unrelated brokerage business, or any other indirect form of remuneration, from an investment adviser as compensation for referring clients to the adviser's investment management service; and (2) prohibit any broker-dealer from receiving any part of an investment advisory fee, or any other direct remuneration, as compensation for referring clients to an adviser's investment management service, except that a broker-dealer should be permitted to receive a reasonable, fully-disclosed, one-time, finder's fee to compensate him for services in connection with introducing the client to the adviser. Also, a broker-dealer should be permitted to receive brokerage or direct compensation from an adviser for demonstrable, tangible services such as research which enhance the adviser's overall capability to serve its clients. This is consistent with the approach taken by the Commission with respect to the use of investment company brokerage by its adviser to compensate brokers for research, as distinguished from sales.12/

B. Choice of Brokers

As a general principle, the Committee believes it is desirable for the client of an investment management service to select his own broker. However, the Committee does not believe that there is anything

12/ See Securities Exchange Act Release No. 9598 (May 9, 1972).

objectionable about a limitation on the selection of a broker if (1) there is a demonstrable benefit to the client (e.g., the broker selected by the investment manager performs substantial bookkeeping and other services which might not otherwise be available in connection with the investment management service if the client were able to select his own broker), and (2) there are no reciprocal or other arrangements designed to benefit the investment manager (see discussion on fee sharing in Part A of this section).

The investment advisers who are also broker-dealers or affiliated with a broker-dealer should not require their clients to use them or their affiliates as a broker. Any conflict of interest would appear to be obviated by giving the client the choice in the selection of a broker. However, in some cases, a registered broker-dealer may operate an investment management service and receive his compensation solely in the form of brokerage commissions. This type of arrangement may not afford an investor the ideal sort of impartial investment management that an investment adviser with no broker affiliations might be able to provide. Such a broker-dealer must necessarily incur substantial costs in supervising many accounts on a continuous basis. There must necessarily be a strong impetus for such a broker-dealer to engage in transactions which may not necessarily be in the best interests of clients in order to generate adequate revenue. On the other hand, assuming that the broker-dealer does not excessively trade clients accounts, the investor using such a service could realize a substantial saving.

The question then comes down to whether the conflict of interest is so great as to necessitate prohibiting a broker-dealer from operating an investment management service for brokerage compensation only. The Committee has not made any detailed investigation of this problem, but believes that an investment management service of this type should be subject to very close scrutiny by the Commission.

C. Placement and Execution of Brokerage Orders

Related to the choice of brokers is the problem of the placement and execution of orders on behalf of accounts in an investment management service. One comment letter noted that banks have certain advantages over investment advisers in that they are able to combine or bunch their clients orders and pass along substantial commission savings to clients.[13/] The writer states that, in contrast, an adviser with no broker affiliations cannot effect brokerage transactions in its name as nominee for clients, since, according to a Commission staff interpretation, this would require the adviser to register as a broker-dealer under the Securities Exchange Act.[14/]

13/ Letter from Robert E. Pols, President, Princeton Asset Management, Inc., Nov. 20, 1972. Mr. Pols also asserted that some broker-related management services achieve the same result as banks do by offsetting their fees with commissions. The Committee is not aware of this practice in connection with small account services.

14/ See William Goldberg, Inc., available July 25, 1972.

A member of the New York Stock Exchange may not "bunch" round-lot orders for its clients without charging each client the required commission on his transaction. In addition, bunching of odd-lot orders to make a round lot for unrelated clients may be done only with the prior approval of the clients.15/ It is permissible for an investment manager who holds a limited power of attorney to ask a member firm of the NYSE to bunch odd-lot orders for unrelated clients.

Some investment managers who deal through banks or broker-dealers who are not members of the NYSE may bunch round-lot orders for their clients without charging the required commission. This occurs when the bank or non-member broker-dealer places an order containing bunched round-lots in an omnibus account with a member firm. The member firm would not have knowledge that the single order received through the bank or broker-dealer omnibus account actually represents bunched round-lots for clients of an investment manager who had placed the order through the broker-dealer or bank. The member firm in this instance views the broker or bank, as its customer.

15/ NYSE Rule 372 provides that, "No member or member organization shall, without charging the required commission, execute "bunched" orders, i.e., a combination of orders accepted from several principals, whether members, allied members, or non-members, and executed as one lot." In this connection the NYSE Manual, Paragraph 2411.10, provides that, "A member or member organization shall not combine the orders given by several different customers to buy or sell odd-lots of the same stock, into a round-lot without the prior approval of the customers interested. When a person gives, either for his own account or for various accounts in which he has an actual monetary interest, buy or sell odd-lot orders which aggregate 100 shares or more, such orders shall, as far as possible, be consolidated into full lots, except that selling orders marked 'long' need not to be so consolidated with selling order market 'short'."

The Committee believes that an investment manager has some obligation to monitor the performance of the broker, whether chosen by the manager or the client, in the execution of clients' brokerage transactions. But, if an investment manager uses one broker or substantially limits the client's choice to brokers designated by the manager, it should exercise special care to assure that the broker or brokers continue to execute transactions properly.

At the present time, most small account investment managers place their client's orders separately with one broker designated by the manager or with the client's broker. Some of these investment managers indicate that, under certain circumstances when it is practicable, they will attempt to obtain a bunched execution and thereby permit clients to avoid the odd-lot differential, but not the odd-lot commission. The Committee believes that investment managers who place orders separately should disclose their policies for assuring fairness in the sequence in which orders are placed.

D. Preferential Treatment of Certain Classes of Clients

If any firm which operates a small account investment management service also manages accounts of different classes of clients (e.g., mutual fund, pension or profit-sharing plan or large individual accounts), there is a potential conflict of interest in that the firm may favor one class of clients over the other. The Commission's Institutional Investor Study made an inquiry to determine whether there was any preferential treatment by investment advisers in the management of different types of accounts.16/ When asked if the adviser had a policy with respect to allotments in purchase and sale programs, 34 of the 106 respondents indicated that they had no policy, while 72 stated they had some policy. Of those 72, 11 said they gave priority to particular types of accounts.17/ When asked about how they allocate limited quantities of securities in high demand, 61 respondents said they had no policy.18/

At that time, the Commission did not propose a specific set of guidelines. Only recently did Commissioner Owens call for additional disclosures to determine whether all accounts under management are fairly treated.19/ One comment letter received by the Committee indicated the necessity of preventing preferential treatment in portfolio transactions for the benefit of any class of investors.20/

The Committee considered attempting to delineate guidelines for a policy which would assure equitable treatment of clients of an investment manager, but this appeared to be a problem with implications beyond the scope of this Committee's work. However, the Committee recommends

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16/ Institutional Investor Study Report of the SEC, H.R. Doc. 64 92d Cong., 1st Sess., pt. 2 (1971), pp. 348-374 (hereafter referred to as "Institutional Study Report").

17/ Institutional Study Report, pp. 348-349.

18/ Institutional Study Report, pp. 350.

19/ Hugh F. Owens, "Investment Adviser Regulation: A Subject Too Long Neglected" Address before Money Management Institute (October 12, 1972), p. 6.

20/ Franklin Johnson, letter of November 24, 1972.

that the Commission address itself to this problem. In this connection, the Committee suggests that it would be appropriate for the Commission to establish disclosure requirements cast in terms so as to encourage investment advisers to establish trading allocation policies **to assure** equitable treatment consistent with their fiduciary duties. This will have especially important implications for **the clients of small accounts management services, who are more likely to be short changed by an investment adviser who also manages larger accounts.**

E. Investment Manager Affiliations with Broker-Dealers

Investment management services which are offered by broker-dealers or their affiliates may present some substantial conflict-of-interest problems. For example, an investment adviser which operates a small account service may recommend to, or purchase for, clients securities in which an affiliated broker-dealer is making a market or securities with respect to which such a broker-dealer is participating in a distribution. In those cases, Commission rules adopted under Section 15(c)(1) of the Securities Exchange Act of 1934, which prohibit a broker-dealer from engaging in any fraudulent, deceptive and manipulative practices, impose an obligation on the broker-dealer to make certain disclosures. Rule 15c1-4 under Section 15(c)(1) of the Exchange Act generally requires that a broker or dealer, at or before the completion of each transaction for the account of a customer in a security, give or send to the customer written notification disclosing whether he is acting as a broker for such customer, as a dealer for his own account, or as a broker for both such customer and other persons. Rule 15cl-6 under Section 15(c)(1) generally requires that a broker or dealer who is participating in a primary or secondary distribution of a security give written notice of this fact to his customer at or before the completion of any transaction in that security for the account of such customer. Failure to send the notifications specified by these rules constitutes a "manipulative, deceptive, or other fraudulent device or contrivance" under Section 15(c)(1) of the Exchange Act.

The Committee believes that the contract form or sales literature used by an investment manager should clearly disclose any affiliation with a broker-dealer and whether he intends to recommend or purchase securities in which such a broker-dealer is acting as a dealer or participating in a distribution. Otherwise, the Committee believes that the disclosure required by Rule 15cl-4 under the Exchange Act provides adequate protection for clients of an investment management service operated by a broker-dealer or affiliate thereof when a security recommended to or purchased for clients is one for which such broker-dealer is acting as a dealer or market maker. There may be situations in which a client of a service offered by an investment adviser arguably might not be deemed a customer of a broker-dealer affiliate of the adviser; e.g., where an adviser maintains custody of clients' securities with a bank and transactions for clients are executed in the name of such bank which might be considered the "customer" of the broker-dealer.

In such circumstances, the Committee believes that such an investment adviser should be obligated to make the disclosure specified by Rule 15c1-4. Possibly, only a Commission interpretation would be required to confirm that obligation under existing law.

Similarly, the Committee believes that the disclosure specified by Rule 15c1-6 under the Exchange Act appears to provide adequate protection for clients of a service giving <u>non-discretionary</u> investment management where the manager recommends a security which is offered in connection with a distribution in which an affiliated broker has an interest or participation. However, in the case of an investment management service operated on a <u>discretionary</u> basis, the possibilities for overreaching when an investment manager purchases securities distributed by an affiliated broker-dealer, appear to require more than disclosure. In these instances, the investment manager is in a position quite similar to that of an investment adviser and other affiliates of an investment company. The abuse of dumping into investment company portfolios worthless or other undesirable securities underwritten by affiliates of investment company management prompted the enactment of Section 10(f) of the Investment Company Act.[21/] This section

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21/ The legislative history of the Investment Company Act indicates that "Some investment companies are organized to be operated essentially as discretionary brokerage accounts, with the insiders obtaining the brokerage commission. In many instances the abuses are more subtle but just as injurious to the investor. The public's funds are used to further the banking business of the insiders, to obtain control of various industrial enterprises, so that the emoluments of this control will flow to these controlling persons, and otherwise to serve the personal interests of the sponsors and management." Statement of Robert E. Healy, Commissioner, SEC, Hearings on S. 3580, Subcomm. on Securities and Exchange, Senate Committee on Banking and Currency 76th Cong., 3rd Sess, pt. 1, (1940), p. 37.

prohibits a registered investment company from purchasing any security underwritten by certain of its affiliated persons during the distribution of such security, unless it obtains a Commission exemptive order or qualifies for exemptive treatment pursuant to the rules adopted under Section 10(f).

The Committee believes that the same dangers which resulted in the enactment of Section 10(f) of the Investment Company Act warrant similar treatment for small account management services operated on a discretionary basis. Therefore, the Committee believes that an investment manager offering such a service, which is or is affiliated with a broker-dealer, should be prohibited from purchasing for clients any security with respect to which it or its affiliated broker-dealer is acting as an underwriter during the existence of the distribution or selling syndicate, unless the client makes a request for such purchase unsolicited by the investment manager or affiliate. This recommendation could be implemented by the Commission by adopting a rule pursuant to Section 206(4) of the Investment Advisers Act which authorizes it to "define and prescribe means reasonably designed to prevent, such acts, practices and courses of conduct as are fraudulent, deceptive, or manipulative." In this connection, pursuant to its authority in Section 206A of the Advisers Act, the Commission, by rules or orders, could exempt certain types of transactions or particular transactions to the extent such exemptive rules or orders are consistent with the protection of investors.

F. Publicly-held Investment Managers and Affiliates

In cases where a small account investment management service is operated by a person whose securities are publicly-held,or such person has a publicly-held affiliate,a conflict of interest may arise. For example, if the service is operated by an investment adviser which has an affiliated broker-dealer which is publicly-held, the adviser must decide whether the securities of such broker-dealer should be recommended to or purchased for clients. The Committee believes that the most effective way to obviate these apparent potential conflicts of interest is for the Commission to prohibit investment advisers from recommending or purchasing such securities on terms similar to those described in Part E in the Committee's recommendation regarding investment managers purchasing for clients securities underwritten by affiliated brokers.

G. Investment Managers With No Broker-Dealer Affiliations

Conflicts of interest may also occur in the operation of an investment management service by an investment adviser even in the absence of an affiliation with a broker-dealer. Such a conflict may arise if an investment adviser acting as principal, sells or purchases a security for the client's account. A conflict may also arise if an investment adviser, acting for a person other than a client, effects a sale or purchase of a security for the client's account. In this connection. Section 206(3) of the Investment Advisers Act prohibits an adviser from knowingly effecting such transactions, unless, before the completion of each such transaction, the adviser discloses in writing the capacity in which he is acting and obtains the consent of the client. 22/ Therefore, it appears that the Advisers Act presently provides some protection for clients of an investment management service against the most obvious forms of self-dealing. However, since the requirements of Section 206(3) cover only an investment adviser, it may be possible for persons affiliated with an adviser to avoid these requirements by indirect means. The Committee believes that the Commission should be alert to the development of any such practices.

22/ The requirements of Section 206(3) do 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.

H. Use of Inside Information

When an investment adviser or its affiliate purchase or sell the same securities which the adviser is purchasing or selling for clients or recommending that clients purchase or sell, overreaching of clients may result. As mentioned above, Rule 204-2(a)(12) requires an adviser to keep records of its and its affiliates' transactions. These recordkeeping rules were adopted after S.E.C. v. Capital Gains Research Bureau.[23/] In that case, the Supreme Court affirmed the granting of an injunction against an investment adviser which purchased stock shortly before publishing recommendations that the stock be purchased and then shortly afterwards profitably sold the stock. The Court held that since the adviser did not disclose this practice, referred to as "scalping," it operated as a fraud and deceit upon any client or prospective client within the meaning of Section 206 of the Advisers Act.

In adopting Rule 204-2(a)(12) the Commission stated that the rule was intended to afford the Commission valuable information which will assist it in determining whether a further rule to prevent scalping is necessary.[24/] The Commission never adopted any such further rule, but the Committee believes it should, especially in view of the growth

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23/ 375 U.S. 180 (1963).

24/ Investment Advisers Act of 1940 Release No. 203 (August 11, 1966).

of investment management services which permit managers to exercise discretionary authority or substantial influence over large amounts of customers funds. Such a rule is necessary not only to prevent the type of scalping that occurred in the Capital Gains case, but also other uses of inside information that may result in market activity for the benefit of personnel of investment advisers.

Most firms surveyed by the questionnaire stated that they and their affiliates may be purchasing and selling securities which they are recommending for purchase or sale, or purchasing or selling for clients. Also, most of these firms also stated that they had restrictions on trading activity of the firm and its personnel. However, the restrictions ranged from elaborate codes of ethics with stringent requirements to mere disclosure. In view of the difficulty of being certain of the extent to which a fiduciary is under disabilities with respect to transactions for his own account or for the accounts for which he is responsible, the Committee recommends that the Commission adopt specific rules in this area. In this regard, the Commission's proposed rules under Section 17(j) of the Investment Company Act of 1940 might be some guide.[25/]

25/ See Investment Company Act Release No. 7581 (December 26, 1972). This proposal deals with trading by affiliated persons of an investment company in securities which the investment company is trading or contemplates trading.

I. Use of the Term "Investment Manager"

As a result of its study and discussions, the Committee discovered that there is a great deal of confusion about what it means to be an investment manager. Of the firms operating investment management services surveyed, the Committee found the following:

1. Several registered investment advisers use the title "investment counsel." Section 208(c) of the Investment Advisers Act 26/ requires this type of firm's investment management service to furnish "investment supervisory services". 27/ All of these firms reported that they do provide investment supervisory sources.

2. Several registered investment advisers, who do not use the title "investment counsel," purport to furnish investment supervisory services. In most instances it appears that these firms would be entitled to call themselves "investment counsel," assuming that their representation as to the nature of their service is accurate. Most of these firms refer to themselves as "investment managers" and use descriptive language such as "professional investment management," "individual investment programs," and "full investment management."

26/ Section 208(c) makes it unlawful for any person registered under the Investment Advisers Act "to represent that he is an investment counsel or to use the name "investment counsel" as descriptive of his business unless (1) his or its principal business consists of acting as investment adviser, and (2) a substantial part of his or its business consists of rendering investment supervisory services." In this connection, the Commission staff prepared a brief statement on the legislative history of the Investment Advisers as it relates to investment counselling. The **statement is attached as Appendix E to the report.**

27/ "Investment supervisory services" is defined in Section 202(a)(13) of the Advisers Act as "the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client."

3. Several are registered broker-dealers who do not use the term investment counsel. One of these firms said it did not furnish investment supervisory services, but nevertheless said it provided "professional management." Another firm said it did provide investment supervisory services and called itself a "total responsibility investment organization."

When a person holds himself out to the public as an investment manager, or as part of a description of his business states that he "manages" money or investments, he may lead investors to believe that he is providing more than the kind of general investment advice provided by an investment advisory market letter. The Committee believes that many investors would believe that a person purporting to be an investment manager would furnish individualized treatment or investment supervisory services. This is particularly so when such a person obtains discretionary trading authorization from the client. Therefore, the Committee believes that the Commission should reduce the confusion caused by the undiscriminating use of labels and clarify the duties of a firm which manages an investor's money.

The Commission could implement this recommendation by adopting a rule pursuant to its authority under Section 206(4) of the Advisers Act to "define and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative," which would prohibit any investment adviser from directly or indirectly representing that he is an investment manager or from using that designation as descriptive of his business, unless such adviser furnishes investment supervisory services. In this connection, the discussion in Section IV of the report on "individualized service," might be helpful to the Commission in developing guidelines on what constitutes "investment supervisory services."

The Committee believes that this recommendation is consistent with the policy embodied in Section 208(c) of the Advisers Act and with the general purposes of that Advisers Act which recognizes the "delicate fiduciary nature of an investment advisory relationship" 28/ and the personalized nature of certain advisory relationships. 29/

28/ See S.E.C. v. Capital Gains Research Bureau, *supra*, note 23, at p. 191.

29/ See Senate Rep. 1775, 76th Cong., 3rd Sess. (1940), p. 22.

VI. APPLICABILITY OF THE INVESTMENT ADVISERS ACT OF 1940 TO A REGISTERED BROKER-DEALER WHICH OPERATES AN INVESTMENT MANAGEMENT SERVICE FOR BROKERAGE COMMISSIONS ONLY

An investment management service can be operated by a registered broker-dealer on either a discretionary or non-discretionary basis. The characteristic common to both types of services is investment advice on a continuous basis with respect to specific assets of clients. If a registered broker-dealer operates such a service, the question arises as to whether it must register as an investment adviser under the Investment Advisers Act of 1940.

Section 202(a)(11)(C) of the Advisers Act excepts from the definition of "investment adviser" "any broker or dealer whose performance of such services [i.e., investment advisory services] is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." It is clear that a broker-dealer would have to register under the Advisers Act if it charged a fee, or otherwise received compensation over and above ordinary brokerage commissions, for its services in connection with the operation of an investment management service. However, the question remains as to whether the investment advisory services rendered by such a broker-dealer would be "solely incidental to the conduct of his business as a broker or dealer" if it did <u>not</u> receive special compensation.

The Committee does not believe that the exclusion in Section 202(a)(11)(C) should be available to a broker-dealer who actively solicits customers for an investment management service. However, the Committee recognizes that brokers have traditionally handled discretionary accounts for customers. In situations where a broker merely accepts discretionary trading authority from clients as an accomodation to clients, it would appear that the investment advice rendered in connection therewith should be deemed solely incidental to its business as a broker. Of course, advice ordinarily given by a broker to non-discretionary account customers as to the merits of purchasing or selling particular securities should also be deemed to be "solely incidental."

If the Commission decides to deny the exclusion in Section 202(a)(11)(C) of the Adviser's Act to a broker-dealer which actively solicits customers for an investment management service, it would substantially facilitate the implementation of the Committee's recommendations, since it would avoid the necessity of adopting rules under the Securities Exchange Act applicable to broker-dealers comparable to those under the Advisers Act.

VII. APPLICABILITY OF COMMITTEE RECOMMENDATIONS TO BANKS

The Committee has focused primarily on the activities of registered investment advisers and registered broker-dealers who provide small account investment management services. However, as previously indicated, questionnaires were sent to some banks which the Committee thought might be providing small account services.

The Commission generally does not have jurisdiction over banks as such, but it has claimed banks can be liable under the registration provisions of the federal securities laws by reason of the promotion or sale of "securities" which fall outside the exemption for securities issued or guaranteed by a bank because they are issued by a separate entity created by the bank for the purpose.30/ Also, the exemption from the registration requirement under the Securities Act, if it is available because of the exemption in Section 3(a)(2) of that Act for bank securities or because of the absence of any public offering, is not a complete exemption, but leaves in effect the provisions of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act, as well as Rule 10b-5, which come into play when, in connection with the sale of a security, a misrepresentation is made or a fraudulent or deceitful device, scheme, artifice, act, practice or course of business can be found. The Committee has not explored the extent or

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30/ See Section 3(c)(3) of the Investment Company Act and Section 3(a)(2) of the Securities Act. For a discussion of the applicability of the Investment Company Act and the Securities Act to bank common trust funds and commingled managing agency accounts, see Hearings on Common Trust Funds, Subcomm. of House Comm. on Government Operations, 88th Cong., 1st Sess.(1963), pp. 3-6; Hearings on H.R. 8499 and H.R. 9410, Subcomm. on Commerce and Finance of House Comm. on Interstate and Foreign Commerce, 88th Cong., 2d Sess. (1964), p. 26; Hearings on S. 2704, Subcomm. on Financial Institutions, Senate Comm. on Banking and Currency, 88th Cong., 2d Sess. (1966) pp. 133, 629; and cf. Investment Company Institute v. Camp, 401 U.S. 617 (1970).

propriety of the exemptions currently enjoyed by the banks, but the Committee does believe that it would be desirable for the banks to follow the guidelines to the extent that they engage in providing investment management services to small accounts. In this way, they would reduce and perhaps avoid entirely whatever possibility now exists of attack on their small account operations under the federal securities laws.

VIII. OTHER RECOMMENDATIONS

A. Professional Qualifications and Financial Responsibility of Investment Advisers

The Committee concerned itself primarily with the problems relating to small account management services. However, the professional and financial qualifications of investment advisers have implications far beyond the field of small account management. The Investment Advisers Act imposes no standards, nor do most states; those states that do,provide only minimal investor protection. In this connection, the Committee shares the concern recently expressed by Commissioner Owens about the need for improvement in regulation under the Advisers Act. 31/

With respect to professional qualifications, the Advisers Act merely calls for disclosure of the education and work experience of certain persons associated with the adviser. Moreover, the Act requires only disclosure of this information in the advisers registration statement filed with the Commission; there is no obligation even to communicate it to clients. This is in contrast to broker-dealers whose principals must pass an examination administered by the National Association of Securities Dealers or the Commission, and may have to meet additional requirements imposed by national securities or exchanges on their members.

31/ "Investment Adviser Regulation: A Subject Too Long Neglected," Address by Hugh F. Owens before the Money Management Institute (October 12, 1972), p. 26. Similar concern about the absence of minimum qualifications for investment advisers was also expressed in the Report of the Special Study of the Securities Markets of the S.E.C., H.R. Doc. 95, 88th Cong., 1st Sess. pt. 1 (1963) pp. 146-148 ("Special Study").

Accordingly, the Committee recommends that the Commission adopt a rule or, if it deems it necessary, propose legislation, which would establish minimum qualifications for personnel of investment advisers. In this regard, the Commission should consider the following suggested criteria:

1. Passing an examination which would test knowledge of the Federal securities laws, in particular the Advisers Act, the workings of the securities market and methods of security analysis, or, in lieu thereof, obtaining a certificate from a recognized professional organization, such as the Chartered Financial Analyst certificate offered by the Institute of Chartered Financial Analysts.

2. For personnel having direct management and supervisory responsibility, a reasonable period of full-time employment in the investment advisory or securities industry, in an investment management capacity in a trust department or insurance company, or similar experience.

With respect to the financial responsibility of investment advisers, the Advisers Act has no capital requirements for registered advisers. This is in contrast to registered broker-dealers, which must maintain the net capital specified by the Securities Exchange Act or by exchanges. Customers of broker-dealers are afforded additional protection by the insurance coverage of the Securities Investor Protection Corporation.

In the absence of minimum capital requirements for registered advisers, their clients have little or no protection against loss occassioned by (a) embezzlement or conversion of assets by personnel of the adviser, (b) negligence or breach of fiduciary duty, or (c) insolvency of the investment adviser. The risk of loss, of course, is much greater if an adviser maintains custody of clients securities and funds. It appears that only a small number of advisers maintain custody of clients' assets. Thus, the possibility of loss by clients by reason of embezzlement or conversion is limited at the present time. However, even where the adviser does not have custody of clients' assets, clients still stand to suffer loss if the adviser commits a breach of fiduciary duty, engages in negligent conduct, or become insolvent. In case of insolvency, for example, the client could lose any advance fees he may have paid, and would have to contend with the interruption of the service and the inconvenience of having to locate another adviser, which could be even more costly.

The Committee believes that there is a very real need to assure the minimum financial responsibility of investment advisers, and that the Commission should propose legislation which would authorize it to adopt rules to specify minimum capital requirements for registered investment advisers. Any requirements should be designed to provide the minimum capital necessary for the adviser to furnish the service he offers and adequate protection for clients against the types of loss discussed above, taking into consideration whether or not the adviser maintains custody of clients' assets.

Until the foregoing recommendation is implemented, the Committee recommends that the Commission specifically require that an investment advisory firm operating a small account investment management service cease soliciting new clients and decline to accept additional funds from existing clients if the firm knows of any facts which might materially adversely affect its ability to continue operations.

B. Self-Regulation

The Committee recommends that the Commission encourage the investment advisory industry to establish the facilities to regulate its own conduct. In this regard, the Commission should propose legislation to enable an appropriate industry organization to exercise self-regulatory powers, subject to Commission oversight. It should be noted that a proposal for self-regulation was made by the Commission's Special Study of the Securities Markets in 1963.[32/]

Self-regulation in the investment community is already an accepted practice, employing the National Association of Securities Dealers and the various exchanges to oversee the activities of broker-dealers. From time to time, questions have been raised as to the effectiveness of self-regulation citing the difficulties which arose in the securities industry in the late 1960's. Any weakness displayed by the system in that instance appears to have resulted from inadequate execution of the system rather than any weakness or failure in the concept and structure of the system.

32/ Special Study, pt. 1, p. 159. In this connection, it was recommended that membership in an appropriate self-regulatory group (exchange or national securities association or affiliate thereof) should be a prerequisite to registration as an investment adviser.

An industry such as the investment advisory industry, which is fragmented into many small firms, lends itself to self-regulation even more than those industries which are more concentrated in large units. Self-regulation over a period time could provide a greater insight into the problems as they may develop. This would be far more desirable than attacking the problems after the fact when someone has been injured and the responsible parties may no longer be engaged in the profession, which works to the detriment of the investing public and those remaining organizations which suffer from association with the adverse publicity.

A self-regulatory body could have the additional advantage of providing a vehicle for the implementation of the Committee's recommendations regarding professional and financial qualifications of advisers. In this way, self-regulation could be a very useful adjunct to the Commission's administration of the Advisers Act.

APPENDIX A

FOR RELEASE: Thursday, October 12, 1972

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SECURITIES ACT OF 1933
Release No. 5321
SECURITIES EXCHANGE ACT OF 1934
Release No. 9819
INVESTMENT COMPANY ACT OF 1940
Release No. 7423
INVESTMENT ADVISERS ACT OF 1940
Release No. 341

Chairman William J. Casey announced today the formation of an advisory committee to assist the Commission in developing clearer policies and guidelines in the area of investment management services for individual investors.

In describing the committee's assignment, Chairman Casey said: "Through computer technology it now appears feasible to provide individualized investment advisory services to investors who have relatively small amounts of money to invest. These services can substantially reduce the disparity between research information and investment management available to institutional, as opposed to individual investors, by providing the direct investor with continuous account supervision based upon his individual needs."

"However, there is a great deal of uncertainty about the applicability of the Investment Company Act of 1940 and the Securities Act of 1933 in this area. An advisory service which makes large-scale solicitations of relatively small accounts and provides substantially the same advice to clients can become functionally indistinguishable from an investment company. Representations as to 'individualized' treatment of clients may in such a case also raise questions under the antifraud provisions of the Investment Advisers Act of 1940. On the other hand, notwithstanding some overlapping investment advice, such a service might actually provide individualized service.

"In the absence of clear standards, some investment advisory firms may have been inhibited from establishing non-pooled individualized advisory services. Others inadvertently may be operating advisory services in a manner contrary to the securities laws. The advisory committee will attempt to resolve questions in these areas and formulate policies and guidelines as well as recommend rule proposals."

The members of the advisory committee are listed below.

Douglas D. Milne - Chairman
President
Lionel Edie & Co.
New York, NY

Lawrence Tilton
Vice President
John P. Chase, Inc.
Boston, MA

George A. Blackstone, Esq.
Heller, Ehrman, White & McAuliffe
San Francisco, CA

John Jansing
Sr. Vice President
Bache & Co.
New York, NY

William Everdell, Esq.
Debevoise, Plimpton,
McLean & Gates
New York, NY

H. Spencer Everett
Secretary and General Counsel
T. Rowe Price and Associates
Baltimore, MD

Dana H. Danforth, President
Danforth Associates
Wellesley, MA

<u>For the Staff</u>

Alan Rosenblat
Chief Counsel
Division of Investment
Company Regulation

By the Commission.

Ronald F. Hunt

Secretary

APPENDIX B

FOR RELEASE Friday, October 27, 1972

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

SECURITIES ACT OF 1933
Release No. 5325
SECURITIES EXCHANGE ACT OF 1934
Release No. 9834
INVESTMENT COMPANY ACT OF 1940
Release No. 7455
INVESTMENT ADVISERS ACT OF 1940
Release No. 344

At the request of the Advisory Committee on Investment Management Services for Individual Investors, which was established on October 12, 1972 (Securities Act Release No. 5321), the Commission is publishing the following memorandum:

"The Securities and Exchange Commission has appointed the undersigned as members of an Advisory Committee on Investment Management Services for Individual Investors. Besides conferring with the Commission and its staff, the Committee is seeking the comments and suggestions of the Bar and other interested persons. Since the Committee must conclude its business by January 6, 1972, it is essential that all comments and suggestions be received not later than November 22, 1972.

As indicated by Chairman Casey in the Commission's release of October 12, 1972, the Committee's general purpose is to assist the Commission in developing clearer policies and guidelines in the area of investment management services for individual investors. More specifically, the Committee will:

1. Advise the Commission on how various types of investment management services are set up and operated including those offered by broker-dealers, as well as by investment advisers.

2. Advise the Commission on (a) the extent to which the various types of services afford investors individual investment advice (i.e., "investment supervisory services," as defined in Section 202(a)(13) of the Investment Advisers Act of 1940); and (b) the criteria which should be used to determine whether individual investment advice is given.

3. Advise the Commission on the extent to which any conflicts of interest or other actual or potential abuses are presented by investment management services, including any problems that may arise in connection with advertising or suitability.

4. Determine whether any problems relating to broker-dealer and investment adviser regulation are presented by these services.

5. Review and evaluate Commission and staff positions on investment management services in light of information obtained by the Committee.

6. Advise the Commission as to what types of investment management services should and should not be subject to the Investment Company Act of 1940 and to recommend appropriate criteria or guidelines on which to base a determination in this regard.

7. Recommend with respect to those services for which regulation under the Investment Company Act is not deemed necessary, appropriate interpretations, rules, regulations, disclosures, guidelines or legislation under the Advisers Act or the Exchange Act or otherwise that may be necessary to protect investors.

All persons and organizations are invited to submit their comments and suggestions to the Committee. All submissions must be in writing (with 10 copies) so that they can be considered expeditiously by all members of the Committee. Please do not discuss named cases or individuals, since the Committee is not an ombudsman to represent a person or corporation with a pending matter or a past grievance.

Specific circumstances in terms of ABC Corporation, or Mr. X and Mr. Y are welcomed. Suggestions, comments or criticisms of a general nature are only as valid as the underlying facts; so specific (although anonymous) sets of precise facts are sought, together with your conclusion or recommendation based thereon.

The written material should be forwarded to the Advisory Committee on Investment Management Services for Individual Investors, c/o Securities and Exchange Commission, Washington, D.C. 20549, Attention: Alan Rosenblat, Chief Counsel, Division of Investment Company Regulation. All submissions will be available for public inspection. We welcome and will appreciate all comments and suggestions."

Douglas D. Milne, Chairman
George A. Blackstone
H. Spencer Everett, Jr.
Dana H. Danforth
William Everdell III
John Jansing, Sr.
Lawrence Tilton
Alan Rosenblat

Ronald F. Hunt
Secretary

APPENDIX C

For RELEASE February 6, 1970

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

Litigation Release No. 4534

The Securities and Exchange Commission announced the filing of a complaint for injunction in the United States District Court for the Southern District of New York against First National City Bank, Merrill Lynch, Pierce, Fenner and Smith, Inc. and Special Investment Advisory Service. The complaint alleges that the defendants have engaged in violations of Section 7(b) of the Investment Company Act of 1940, by operating an unregistered investment company, Special Investment Advisory Service ("SIAS"), and offered and sold SIAS securities to the public in violation of Sections 5(a) and (c) of the Securities Act of 1933.

The Commission also announced that, pursuant to a Stipulation and Undertaking entered into by the parties, the Court has entered an Order disposing of the action, but retaining jurisdiction to ensure that all of the terms and conditions of the Stipulation and Undertaking are fulfilled. The Stipulation and Undertaking, which is described more fully below, requires defendants to cease forthwith from offering, selling or redeeming securities issued by Special Investment Advisory Service ("SIAS") and from selling or purchasing securities for the account of SIAS, in the absence of applicable statutory exemptions, unless and until defendants have complied with the registration requirements of the Securities Act of 1933 and the Investment Company Act of 1940. In addition, defendants undertake to refrain in the future from any other activities which, taken together, are of similar purport and object as the activities complained of in the Commission's complaint for injunction, except in compliance with applicable provisions of law. Defendant Merrill Lynch, Pierce, Fenner and Smith, Inc., also agrees to terminate its relationship with other banks and persons which have offered services similar to SIAS, including American Security & Trust Company, Washington, D.C.; First National Bank of Minneapolis; Continental Illinois National Bank and Trust Company, Chicago; and Girard Trust Bank, Philadelphia, unless applicable registration requirements have been complied with by those other banks and persons. It should be noted, however, that the above-named banks are not parties to the Commission's action or to the Stipulation and Undertaking.

Summary of Complaint

The following is a summary of the allegations of the complaint, which are not admitted by the defendants.

Since at least October 1, 1964, defendants have violated Sections 5(a) and 5(c) of the Securities Act of 1933 and Section 7(b) of the Investment Company Act of 1940 by offering and selling unregistered securities issued by SIAS, an unregistered investment company which has a present value of approximately $35 million and over 1,000 securityholders and by SIAS's failure to register under the Investment Company Act. The named defendants are First National City Bank ("Citibank"), Merrill Lynch, Pierce, Fenner and Smith, Inc. ("Merrill Lynch"), a broker-dealer registered with the Commission, and Special Investment Advisory Service ("SIAS"), an investment company (or "mutual fund") organized by Citibank and Merrill Lynch as an unincorporated fund primarily engaged in the business of investing, reinvesting, owning, holding and trading in securities. Citibank and Merrill Lynch are the sponsors, promoters, trustees, depositors, investment advisers and underwriters for SIAS.

On approximately October 1, 1967, Citibank commenced a nationwide and overseas advertising campaign in newspapers and magazines to encourage investments in SIAS. Merrill Lynch participated in this promotional effort. Through its advertising campaign and otherwise, Citibank offered securities issued by SIAS in such a manner as to assure SIAS investors that their investments would receive the same individualized and personal attention and supervision which Citibank purports to provide by its regular investment advisory service, which is designed for investments of at least $200,000. SIAS investors are required to invest at least $25,000.

The securities issued by SIAS have certain characteristics, including a power of attorney permitting Citibank to trade for the investor's account through Merrill Lynch, a letter agreement with Citibank and a stated objective of long-term capital growth or income. Merrill Lynch acts as a custodian for the securities and cash comprising the SIAS assets and as the exclusive broker for executing transactions in such securities.

In connection with the offer and sale of the securities issued by SIAS, defendants have omitted to state certain facts concerning the investment company which were necessary in order to enable the persons to whom such securities were offered to make informed judgments with respect thereto. Thus, while Citibank and SIAS have publicly stated that the investment of each investor in SIAS would receive personalized or individual attention, it was not disclosed to investors that--

(1) The funds received by SIAS from investors were invested in a virtually identical manner in one of two groups of securities, one for investors whose objective was long-term capital growth and the other for investors whose objective was income.

(2) The initial investment for investors whose objective was long-term capital growth was in eight common stocks in accordance with predetermined percentages.

(3) Approximately 47 per cent of the assets held by SIAS for such investors were invested in securities issued by companies affiliated or controlled by persons who are also directors of Citibank.

(4) After the initial investment had been made for such investors, all decisions by Citibank to buy or sell a security for SIAS were generally applied uniformly to the entire fund.

(5) Pursuant to instructions from Citibank, Merrill Lynch executes all transactions for SIAS, and because of the structure and operation of SIAS, these transactions were not executed in the best manner for both SIAS and the investors.

(6) Although under the agreement with Citibank the investor assumed full responsibility for the choice of broker, in fact, in order to invest in SIAS, all investors were required to open an account with Merrill Lynch which executed all transactions for SIAS.

Merrill Lynch discussed with several other banks the possibility of forming unregistered investment companies similar in operation to SIAS, at least three of which were subsequently organized and in which Merrill Lynch is similarly involved.

Although SIAS is an investment company within the meaning of the Investment Company Act, since it is and holds itself out as being engaged primarily and proposes to engage primarily in the business of investing, reinvesting and trading in securities, it is not registered as such with the Commission. In addition, the securities issued by SIAS and offered and sold by all defendants have not been registered under the Securities Act of 1933. Therefore, the Commission's complaint asks the Court to grant a preliminary and permanent injunction restraining defendants from offering or selling any security issued by SIAS or from operating SIAS until the applicable registration requirements of the Securities Act and Investment Company Act have been complied with by defendants.

Summary of Stipulation and Undertaking

The Stipulation and Undertaking contains an agreement by the defendants, enforceable by the Court, to forthwith permanently cease offering or selling any security issued by SIAS or operating SIAS, and defendants agree that they will not in the future engage in any similar activities which, taken together, are of similar purport and object as the activities complained of in the complaint for injunction except in compliance with the registration requirements of the Securities Act and Investment Company Act. Citibank will send to each person who has invested through SIAS a notice (approved by the Commission) which gives the investor the opportunity to receive securities or cash which have been held for him by SIAS or to transfer or sell such securities. Citibank is also permitted to offer to any person whose investment account is not such as to warrant Citibank providing investment advice and related services on an individual basis, an investment advisory service on a non-discretionary basis only, pursuant to which, for a fee (which will be higher than the fee currently charged SIAS investors), Citibank would make investment recommendations to such persons; and any person deciding to act upon such recommendations would transmit any order to buy or sell securities to a broker-dealer selected from a list of at least three such broker-dealers provided by Citibank.

Merrill Lynch, which, as noted, has participated in services similar to SIAS for other banks, agrees that it will terminate such participation, although its services may be utilized in connection with the non-discretionary type of service described above.

Defendants state that they deny that there is any validity in the claims asserted by the Commission in the complaint or any illegality or impropriety in any of defendants' past acts or practices. The Stipulation and Undertaking does not constitute an admission of the existence of any private right of action against any defendant, but it does not prejudice, limit or otherwise affect any such right which may exist against any defendant on the part of any person who invested through SIAS.

Summary of Order

The Court's Order approves the terms of the Stipulation and Undertaking and orders that the complaint be dismissed, provided that the Court will retain jurisdiction over the parties and subject matter for the purpose of ensuring that all of the terms and conditions of the Stipulation and Undertaking are fulfilled.

APPENDIX D

Sample Personal Data Questionnaire for Prospective Clients of a Small Account Investment Management Service

1. Name

2. Address

3. Home Telephone: Business Telephone:

4. Social Security No.

5. Occupation: Spouse's Occupation:

6. Name, Age, and Relationship of Dependents:

7. Status of your health and that of your dependents:

8. Total Life Insurance in Force:
   Do you consider this adequate coverage?

9. Amount of emergency funds maintained separate from investment funds?

   Do you consider this adequate?

10. a. Approximate annual income before taxes and sources thereof (your and spouse's salaries, securities, real estate, trust fund, or other sources)

    b. Approximate maximum tax bracket

11. Type and approximate value of any real estate in which you have an interest, including your residence.

12. Itemize your major debts and liabilities (including brokerage margin accounts) and amounts thereof and the approximate annual cost or servicing each.

13. Are you covered by a retirement plan of your employer? Describe briefly any expected benefits from such a plan.

14. When do you expect (or wish) to retire and approximately what annual funds would be required to maintain your preferred life style in retirement?

15. Describe any realized or unrealized capital gains or losses (indicate short or long term) during the current tax year or significant items or preference income? Describe any carry forward from a previous year's short-term or long-term tax loss.

16. Do you anticipate any changes in your overall financial picture or employment in the foreseeable future? If so, describe.

17. Do you have security holdings not under our supervision? If yes, list name and amount of such securities.

18. State amount of cash you consider to be presently available for investment.

19. List security holdings which will be given over to our supervision, indicating the name of each security, the number of shares (or par value of bonds), the acquisition date, and total cost.

20. State what you consider to be your investment objective (growth, income, balance between growth and income).

21. Are there any stocks, or groups of stocks, in which you would rather not invest?

22. Are there any stocks in your portfolio which will be under our supervision which you would rather not sell?

23. Please furnish any additional information which you think we should have in reviewing your financial condition or in managing your account.

APPENDIX E

Commission Staff Memorandum on Investment Counsel and the Investment Company and Investment Advisers Acts of 1940

In order to place investment management services for smaller investors into proper perspective, it would be helpful to briefly examine the relationship of these services to investment counselling services and the treatment of these latter services by the Investment Company Act and the Investment Advisers Act, both enacted in 1940. At that time it appeared that the business of money management for individuals was commonly referred to as investment counselling.

Traditionally, the services of investment counsel have been limited to those individuals and institutions with substantial funds who desired or required continuous supervision of their investments and a program of investment which took into consideration their entire economic needs.[1/] In 1940, investment counsel set minimum size for accounts which they would administer which ranged from $25,000 to $100,000.[2/] In a letter to the Senate Subcommittee which was holding hearings on the investment company and investment adviser legislation, one investment counsel wrote:

> Size of firm or number of employers is not a criterion as to the competence of any investment counsel concern. The number of accounts and the size of each account has a direct bearing on the relative facility with which a small counsel concern can handle business against a large one. It is a fact that a $1 million account can be more easily handled than 10 $100,000 accounts. 3/

1/ See Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies (Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services), House Doc. 477 (1939), p. 25 (hereafter referred to as "Investment Counsel Study").

2/ *Id.*, p.18.

3/ Statement of Donald Holbrook, Hearings on S. 3580, Subcomm. on Securities and Exchange, Senate Comm. on Banking and Currency, 76th Cong., 3rd Sess., pt. 2 (1940), p. 677 (hereafter referred to as "1940 Act Senate Hearings").

At the same hearings, another investment counsel, Scudder, Steven & Clark ("Scudder"), testified that in 1928 it organized an open-end investment trust for the purpose of taking care of small investors who wanted to employ its services, but had insufficient assets for the firm to provide investment counselling. Prior to that time, Scudder had been trying to supervise funds of $25,000 or less and had found that they were not only unprofitable but that the firm could not invest them to as great advantage as their larger individual accounts.[4/]

The Investment Company Act was enacted in response to abuses in connection with investment trusts, corporations and other media for providing investment by pooling investors funds. However, it is important to note that investment companies operated as an adjunct to an investment counsel's business were granted special treatment with respect to the independence of directors under the Investment Company Act. Section 10(a) of the Investment Company Act requires that at least 40 percent of the board of directors of a registered investment company be independent of the company's investment adviser. However, Section 10(d) requires only <u>one</u> independent director for an investment company managed by an investment adviser which is an

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4/ See Statement of James W. White, General Partner of Scudder, Stevens & Clark, 1940 Act Senate Hearings, p. 700.

an investment counselling firm, subject to certain conditions. 5/

The legislative history of the Investment Company and Investment Advisers Acts indicate that the Congress, the Commission and the industry recognized that where an investment counsel could not provide personal service to investors, it was appropriate and beneficial for investors for the investment counsel to establish a pooled investment vehicle--a no-load mutual fund--for the purpose of furnishing general investment advice to such persons. As David Shenker, Special Counsel of the Commission's Investment Trust Study, stated:

> Subsection (d) [of Section 10 of the Investment Company Act] deals with the special situation, where investment counselors organize investment trusts so that they can make available . . . to people who cannot afford to take their personalized investment services, the same type of services in an investment company. These investment companies are really an adjunct to the investment advisory business. 6/

Aside from pointing out the economic infeasibility of furnishing personal management to smaller investors and the appropriateness of a mutual fund alternative, investment counselling firms expressed their concern at the 1940 hearings about a segment of their industry which they

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5/ Among these conditions are that: The Investment company be an open-end company (i.e., issue a redeemable security); the investment company not charge a sales load on securities issued by it; the investment adviser pay all executive expenses and office rent of the investment company; and the management fee not exceed 1% of the average net assets of the investment company.

6/ Hearings on H.R. 10065, Before a Subcommittee of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3rd Sess., (1940), p. 111.

considered merely "tipsters" and "touts", but who called themselves investment counsel. Investment counsel, at least those who were members of the Investment Counsel Association, considered themselves professionals who furnished clients on a personal basis, competent, unbaised, and continuous advice regarding the sound management of their investments.[7/]

In response to this concern, Section 208(c) was added to the Commission's original bill. As adopted in 1940, Section 208(c) of the Investment Advisers Act made

> It unlawful for any person registered under Section 203 of this title to represent that he is an investment counsel or to use the name investment counsel as descriptive of his business unless such person is primarily engaged in the business of rendering investment supervisory services or unless his registration application as amended or as supplemented by the most recent report on file with the Commission states that such person is engaged or is about to engage primarily in the business of rendering investment supervisory services.

Because the "primary engagement" condition specified in Section 208(c) was found to be too restrictive, this section was amended in 1960 to require that only a "substantial part" of a registered adviser's business consist of rendering investment supervisory services.[8/]

"Investment supervisory services" is defined by Section 202(a)(13) of the Advisers Act as "the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client."

7/ Investment Counsel Study, p. 28.

8/ P.L. 86-750 (74 Stat. 885). In this connection, the Senate Committee Report stated: "This [the present law] operated to exclude from the field of 'investment counsel' outstanding practitioners which happened also to be engaged in related activities "(e.g., publishing factual and statistical information). Senate Rep. 1760, 86th Cong. 2d Sess. (1960), p. 10.

The legislative history of the Advisers Act indicates that this and the other provisions of the Act were intended not only to protect the public from the "frauds and misrepresentations of unscrupulous tipsters and touts," but also to safeguard the "bona fide investment counsel. . . against the stigma of the activities of these individuals." 9/ Also the legislative history shows that Congress clearly recognized that

> . . . with respect to a certain class of investment advisers, a type of personalized relationship may exist with their clients. As a consequence, this relationship is a factor which would be considered in connection with the enforcement by the Commission of the provisions of this bill. 10/

In defining "investment adviser," Congress included a broad spectrum of persons ranging from people who are engaged in the profession of furnishing disinterested, impartial advice to an upper economic stratum of our population to the other extreme--individuals running tipster organizations or using the mails to sell stock market letters. 11/ However, only investment counsel were specially treated by the statute.

9/ Senate Rep. 1775, 76th Cong., 3rd Sess. (1940) p. 21.

10/ Id., p. 22. See also House Rep. 2639, 76th Cong., 3rd Sess. (1940), pp. 28-30.

11/ See Statement of David Schenker, 1940 Act Senate Hearings, p. 47.