

CHAPTER IX

ADMINISTRATION AND ENFORCEMENT OF THE INVESTMENT COMPANY ACT

A. INTRODUCTION

The preceding chapters of this report have been concerned primarily with the broad public policy implications of the substantial growth of the investment company industry since 1940, including those relating to managerial compensation, sales loads, and the allocation of mutual fund brokerage commissions. Proposed legislative amendments and administrative action to deal with these major problems also were discussed.

This chapter is concerned with recurring problems that arise in the day-to-day administration and enforcement of the Act. Most of these problems can be corrected by amendments to the Act which are essentially technical in nature or limited in scope. Others, particularly those problems arising in connection with the enforcement of the Act, will generally require more substantive amendments as well as amendments to the Investment Advisers Act. However, all of the proposed legislative amendments are designed to implement the policies underlying the Congressional intent as set forth in section 1(b) of the Act.¹

The day-to-day administration of the Act involves the regulation of a large and growing number of registered investment companies.² On an annual basis, this includes processing new registration statements under the Investment Company Act; registration statements and post-effective amendments under the Securities Act; filings of proxy soliciting material; periodic reports to the Commission and shareholders; and sales literature filed by investment companies.³ In addition, during the fiscal year ended June 30, 1966, some 213 applications were filed requesting various form of exemptive relief under the Act, and 152 investment company inspections were completed pursuant to a regular inspection program. The Commission also initiated or continued 72 private investigations of investment companies and 12 civil and criminal court actions to enforce provisions of the Act.

¹ Among other things, sec. 1(b) of the Act declares that the interest of investors is adversely affected when investment companies are organized and managed in the interest of insiders; when investment companies issue securities containing inequitable or discriminatory provisions; when control of investment companies is unduly concentrated through inequitable methods of control, and when investment companies are re-organized or control transferred without the consent of the security holders.

² There were 667 active companies registered under the Act as of June 30, 1966.

³ For the year ended June 30, 1966, the following number of filings of investment companies were processed:

1. Registration under the Investment Company Act.....	58
2. Registration statements and post-effective amendments under the Securities Act.....	983
3. Proxy soliciting material.....	408
4. Annual, quarterly and other periodic reports to shareholders.....	2,029
5. Pieces of sales literature.....	2,169

The NASD cooperates closely with the Commission staff in the review of sales literature and has aided the Commission greatly in its efforts to insure that such literature is not misleading.

Since its enactment, the Act has never been the subject of comprehensive amendments reflecting the Commission's experience in its administration of the Act and the significant changes in the industry since 1940.⁴ The Act was the result of a compromise reached by the Commission and industry representatives, at a time of great pressures generated by the outbreak of the war in Europe.⁵ Just as the expansion of the investment company industry has magnified the problems connected with advisory fees, sales compensation and brokerage commissions, so industry growth has accentuated administrative and enforcement problems arising under the Act. Accordingly, it is desirable at this time to complement the Commission's other legislative recommendations with a systematic program of amendments to the Act. Such a program will close unintended gaps and correct anomalies which frustrate the underlying policies of the Act. It can also ease the regulatory burden on those who administer the Act and those who must comply with it, by the elimination, to the extent possible, of recurring problems arising out of ambiguities in the Act.

For discussion purposes, this chapter groups the matters for which legislation is recommended into five categories: (1) Coverage, which is concerned generally with the status of companies under the Act; (2) Management-shareholder relationships; (3) Administrative and other proceedings; (4) Formal amendments, which are concerned generally with updating the Act's provisions and eliminating patent ambiguities or superfluous provisions of the Act; and (5) Investment Advisers Act.

B. COVERAGE

1. Statutory scheme

As indicated in chapter II of this report,⁶ the Act defines an investment company broadly and then exempts or excludes various specific types of companies that fall within the general definition in the Act. If a company falls within the general definition and is not specifically exempted or excluded, it may not as a practical matter engage in any business without registering with the Commission as an investment company subject to regulation under the Act.⁷

Section 3(a)(1) includes as an investment company any issuer of securities which is or holds itself out as being engaged primarily or which proposes to engage primarily in investing, reinvesting, or trading in securities. Section 3(a)(2) covers any issuer which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type or has been in such business and has any such certificate outstanding. Finally, section 3(a)(3) defines as an investment company any issuer which owns or proposes to acquire investment securities valued at more than 40 percent of its total assets of

⁴ From time to time there have been isolated amendments. For example, the Small Business Investment Act of 1958 added sec. 18(k) of the Act, which relieves small business investment companies of certain of the asset coverage requirements in the Act. In addition, bills embodying a limited program for the technical amendment of the Act have been introduced in Congress but have never been voted upon. See e.g., H. Rept. No. 2178 86th Cong., 2d sess. (1960).

⁵ The Commission's Seventh Annual Report to Congress for the fiscal year ended June 30 1941, at page 2, stated that the Act "represents the minimum workable regulation of investment companies." The report went on to state that, "Further experience will presumably indicate a need for minor amendments and may or may not indicate a need for major amendments."

⁶ Counsel for a group of closed-end investment companies at the congressional hearings on the bill has commented, "It is true that the necessity for haste in its drafting is responsible for some imperfections and that with more time available faulty draftsmanship in certain instances would undoubtedly have been eliminated." Jaretski, *The Investment Company Act of 1940*, 26 Washington University Law Quarterly 303, at 346 (1941).

⁷ Pp. 33-35, supra.

⁸ See sec. 7 of the Act, which lists activities which are prohibited to an unregistered investment company.

a specified nature whether or not it holds itself out as an investment company.⁸

Section 3(b)(1) provides an exclusion for a company which does not hold itself out to be and, in fact, is not in the investment company business because it is primarily engaged directly or through wholly-owned subsidiaries "in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities." This exclusion is self-operating, and an issuer which meets the conditions enumerated may rely on the exclusion without the need to seek a determination by the Commission. On the other hand, the exclusion in section 3(b)(2), for a company engaged in a business or businesses other than that of an investment company through majority-owned subsidiaries or through controlled companies, is available only if the Commission grants an order of exception.⁹

Section 3(c) enumerates a number of businesses and companies which are excluded from the definition of an investment company.¹⁰ Although these companies hold securities, their investment activities generally are either peripheral or closely related to their primary non-investment-company businesses or activities.

Finally, companies which do not fall under the purview of any of these exclusions may apply under section 6 of the statute for an order of the Commission granting an exemption in whole or in part from the registration or other provisions of the statute."

2. Determination of status

(a) Requirement of good faith (section 3(b)(2))

The question of a company's status is frequently presented to the Commission in the form of an application pursuant to section 3(b)(2) requesting that the Commission find and by order declare that the applicant is not an investment company. The application, in effect, requests that the Commission find that the applicant is primarily engaged in a business other than that of an investment company, directly or through majority-owned subsidiaries or controlled companies conducting similar types of businesses. Section 3(b)(2) provides that the filing of such application by an issuer other than a registered company shall exempt the applicant for a period of 60 days from all provisions of the Act applicable to investment companies.¹²

In the usual case a company filing an application under section 3(b)(2) is or has been engaged in an industrial enterprise but has acquired investment securities exceeding 40 percent of its assets. For example, it may have sold the assets of unprofitable operating divisions and invested the proceeds in securities pending possible reinvestment in another operating business. At that point it comes within the definition of an investment company under the Act and it may not, for all practical purposes, engage in any business or corporate activity without registering under the Act.¹³ However, if the company files a section 3(b)(2) application seeking an exclusion from regulation under the Act it may continue in business during the grace period.

⁸ *Ibid.*

⁹ In addition, sec. 3(b)(3) excepts any issuer all the outstanding securities of which (other than short-term paper and directors' qualifying shares) are directly or indirectly owned by a company excepted under sec. 3(b)(1) or sec. 3(b)(2).

¹⁰ See discussion of sec. 3(c), pp. 34-35, *supra*.

¹¹ P. 37, *supra*.

¹² The Commission is authorized to extend this 60-day period for cause shown. Sec. 3(b)(2).

¹³ Sec. 7.

However, the 60-day grace period is susceptible to abuse if an applicant which clearly does not come within the provisions of section 3(b)(2) uses the period to engage in activities which would be prohibited to a registered investment company. While the Commission is of the view that the requirement of "good faith" is implicit in the statute itself, argument on the question would be obviated if the Act were clear in this respect. Accordingly, it recommends that section 3(b)(2) be amended to require expressly that applications under the section must be filed "in good faith." Such an amendment is similar to provisions of the Public Utility Holding Company Act of 1935 which expressly require that applications to secure various exemptions under that Act must be filed "in good faith."¹⁴

(b) *Section 3(c) exclusions*¹⁵

The Commission is frequently called upon to make both formal and informal determinations with respect to claimed exclusions under section 3(c) of the Act. Experience with such matters has revealed shortcomings in certain of the exclusions which present difficulties of administration or may result in the unwarranted exclusion of companies from regulation under the Act.

(i) *Factoring, discounting, and real estate businesses (sec. 3(c)(6))*—Section 3(c)(6) provides an exclusion from the definition of an investment company for companies primarily engaged in the factoring, discounting, or real estate businesses. Although these companies are engaged in acquiring notes representing the sales price of merchandise, making loans to manufacturers, wholesalers, retailers and purchasers of merchandise or insurance, and acquiring mortgages and other interests in real estate—thus acquiring investment securities, such activities are generally understood not to be within the concept of a conventional investment company which invests in stocks and bonds of corporate issuers.

However, Companies engaged in these businesses are denied the exclusion if they also engage in issuing face-amount certificates of the installment type or periodic payment plan certificates. This latter limitation reflects the widespread abuse found prior to 1940 in the sale of interests in these types of securities on an installment basis, usually to relatively unsophisticated investors of modest means. Some of these securities were issued by companies in the factoring, discounting, and real estate businesses.¹⁶

In recent years some companies which purport to be primarily engaged in the factoring, discounting, and real estate businesses have actively sought to appeal to this group of unsophisticated investors by issuing redeemable securities which evidences interest in a portfolio of notes, commercial paper, or real estate mortgages." Although

¹⁴ See secs. 2(a)(3), 2(a)(4), 2(a)(7), 2(a)(8) and 3(c) of the Public Utility Holding Company Act of 1935.

¹⁵ Pp. 34-35, *supra*.

¹⁶ David Schenker, Chief Counsel of the Commission's Investment Trust Study, testified during the Senate hearings with respect to the sec. 3(c)(6) exclusion for factoring, discounting and real estate companies that:

"* * * we are trying to work out language which will exempt that type of company if the committee sees fit to do so and yet not let out the type of company which sells its certificates on the installment plan, and whose portfolio consists not of certificates which correspond to those of an insurance company, but whose entire portfolio consists of automobile paper and refrigerator paper." Senate Hearings, p. 182.

¹⁷ Sec. 2(a)(31) of the Act defines "redeemable security" as "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."

these companies have portfolios of commercial paper or real estate mortgages rather than corporate securities, their structure is similar to that of mutual funds. Indeed, the issuance of redeemable securities usually is calculated to capitalize on the popularity of mutual funds.

The Commission on occasion has determined that a company claiming the section 3(c)(6) exclusion was in fact primarily in the business of holding investment securities, and therefore it could not be considered as engaged in the factoring, discounting or real estate businesses for purposes of this exclusion.¹⁸ However, the "business" test upon which such determination hinges is necessarily an uncertain and difficult test to apply in some situations. In the Commission's view there is no justification for exempting from regulation under the Act a company that issues redeemable securities evidencing interests in a portfolio of notes, commercial paper, or mortgages and other liens on and interests in real estate. Section 3(c)(6) could be more effectively administered if the Act were amended to provide specifically that, in addition to existing restrictions, the exclusion is not available to any enumerated company issuing a security redeemable at the election of the holder. As at present, companies which do not issue redeemable securities, face amount certificates of the installment type or periodic payment plan certificates but nevertheless are primarily engaged in the business of investing, reinvesting or trading in securities rather than primarily in the factoring, discounting or real estate businesses would still be subject to regulation under the Act.

(ii) *Companies holding oil, gas, or mineral royalties or leases (sec. 3(c)(11)).*—A similar situation exists with respect to section 3(c)(11) of the Act, which excludes from the definition of an investment company any company substantially all of whose business is holding oil, gas, or other mineral royalties or leases. These companies, like those enumerated in section 3(c)(6), are structured like conventional mutual funds when they issue redeemable securities. Further, they sometimes issue periodic payment plan certificates or face-amount certificates of the installment type. For reasons similar to those referred to in the discussion of section 3(c)(6), these companies and their shareholders should have the protections afforded by the statute. Accordingly, the Commission recommends that section 3(c)(11) be amended so as to remove the exclusion for companies described in that section which issue redeemable securities, face-amount certificates of the installment type, or periodic payment plan certificates.

(iii) *Companies with 90 percent of their investment securities in certain enumerated issuers (sec. 3(c)(8)).*—Although most investment companies invest in the securities of many issuers, a company that limits its investment to the securities of a single issuer is deemed an investment company under the Act unless it controls the business of the issuer. However, section 3(c)(8) excludes from the coverage of the Act a company 90 percent of the value of whose investment securities are represented by securities of a single insurance company, bank, or other enumerated financial institution.¹⁹ The exclusion is available even though the company holds the securities solely for investment purposes and does not manage or control the company whose securities it holds.²⁰ In such cases, the essential purpose of the

¹⁸ Thus, the Commission determined that registration under the Act was required for a "segregated account" maintained by a bank into which the bank transferred automobile paper acquired in the course of its routine banking activities. The bank offered to the public participations in this account which would earn interest at the rate of 4½ percent per annum and which were fully redeemable.

¹⁹ These are enumerated in secs. 3(c)(3), (5), (6) and (7).

²⁰ The legislative history of sec. 3(c)(8) does not indicate the reason for excluding companies of the type described therein from the Act.

company is investing in securities, and not controlling or managing a business other than that of an investment company.

In the Commission's view there is no basis for the exclusion provided in section 3(e)(8), and the Commission recommends that it be deleted from the Act.

(iv) Companies registered under *the Public Utility Holding Company Act* (sec. 3(c)(10)).—Section 3(c)(10) excludes from the coverage of the Act any company ("with a registration in effect as a holding company under the Public Utility Holding Company Act of 1935." Section 5(d) of the Public Utility Holding Company Act provides that a registered holding company may obtain a Commission order declaring that it has ceased to be a holding company, and that upon the issuance of such an order the "registration of such company" ceases to be in effect.

However, a registered holding company may obtain an order under section 3(a) of the Holding Company Act exempting it as a holding company from all the provisions of that Act. On several instances after such orders of exemption have been issued, it has been argued that the company although exempt as a holding company is still "registered" under the Holding Company Act on the theory that deregistration can occur only by the issuance of a section 5(d) order.²¹ It follows, it is argued, that the company is therefore excluded from the coverage of the Investment Company Act. While the Commission has never acceded to this argument, it is desirable to make it express and clear that a company is not excluded from the coverage of the Investment Company Act if it is in effect not subject to regulation under the Holding Company Act. Therefore, the Commission recommends that section 3(c)(10) be amended to make the exclusion available only to companies "(subject to regulation under the Public Utility Holding Company Act of 1935." This language is similar to that in section 3(c)(9) of the Investment Company Act which excludes from the scope of that Act "any company subject to regulation under the Interstate Commerce Act *,"²²

(c) *Series* companies

(i) *Definition*.—As indicated earlier in this report, a number of open-end investment companies registered under the Act issue shares in separate series.²³ Each such series has a separate portfolio which is managed by the same adviser in accordance with a separate investment policy and the interest of a shareholder in the company is limited to the assets of the series in which he holds shares. These so-called series companies were in existence at the time the Act was passed and their existence was contemplated by the provisions of section 18(f)(2).²⁴ Hence, the Commission has not required registration of each series as a separate investment company under the Act.

The individual series of a registered investment company are, for

²¹ An order under sec. 5(d) may be issued only if the company "has ceased to be a holding company." An order under sec. 3(a) may be issued, despite the fact that the company is a holding company, if it satisfies certain standards set forth in that section.

²² Cf. *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y., 1965), where the court stated that the mere possession by a water carrier of an Interstate Commerce Commission "certificate of convenience" did not subject the holder "to regulation under the Interstate Commerce Act" within the meaning of sec. 3(e)(9) of the Investment Company Act.

²³ P. 47, *supra*.
²⁴ That section provides that the definition of "senior security" shall not include, in the case of an own-end company, a series of securities "each of which is preferred over all other . . . series in respect of assets specifically allocated to that . . . series."

all practical purposes, separate investment companies.²⁵ Each series represents a different group of stockholders with an interest in a segregated portfolio of securities having investment policies which are distinct from the policies of other series of the registered investment company. Shareholders of one series should not be lumped together with the shareholders of other series whose interests may be inconsistent with theirs. For example, under section 13(a) any change in the investment policy of a single series must be submitted, in some of these companies, to the shareholders of the entire series company and approved by a majority of all of the outstanding shares of the series company, including shareholders of other series with no interest in the affairs of the particular series.

As discussed in chapter II, a bank and several insurance companies have recently set up "separate accounts" which are registered as investment companies under the Act.²⁶ The interests of participants in one of several accounts created by a single bank or insurance company may be inconsistent with interests of participants in other accounts. Thus, the amendment would make it clear that such separate accounts must each be registered separately under the Act.

The Commission does not believe that these problems are sufficiently serious to warrant upsetting the organizational structure of present series companies. However, for the above reasons, it recommends that existing series companies be prevented from creating new series in the future and that no new series company be permitted to register under the Act.

(ii) *Charge of sales load in exchange of series shares (sec. 11(6)(2)).*— Another problem relating to the operation of series companies exists under section 11(b)(2) of the Act, which permits series companies or their principal underwriters to charge an additional sales load when shareholders in one series exchange their shares for shares in another series. However, section 11(a) prohibits all other open-end investment companies from offering to carry out exchanges except at net asset value.

Section 11(a) was specifically designed to prevent the practices of "switching"²⁷ and "reloading",²⁸ whereby the holders of securities were induced to exchange their certificates for new certificates on which a new load would be payable. The potential for these abuses is just as strong when shares in one series are exchanged for shares in another series as they are in connection with exchanges of shares in other investment Companies.

When the Act was passed some series companies charged a sales load in connection with such exchanges. However, none imposes such charges now and in the Commission's view there is no justification

²⁵ In the course of litigation and administrative proceedings involving various insurance companies issuing or proposing to issue variable annuity contracts, the Commission has had occasion to define entities requiring regulation under the Act and to articulate the reasons for such regulation. The reasons for regulation of such entities apply equally to the separate series. See *Prudential Insurance Company of America, Investment Company Act*, Release No. 3620 (1963), affirmed *sub. nom. Prudential Insurance Company of America v. S.E.C.*, 326 F. 2d 383 (C.A. 3) cert. den., 377 U.S. 953 (1964). There are at present four separate accounts of insurance companies registered as investment companies under the Act. See also pp. 33-37, supra.

²⁶ Pp. 35-37, supra.

²⁷ House Hearings 111.

²⁸ Investment Trust Study, "Companies Sponsoring Installment Investment Plans", p. 90.

for doing so.²⁹ Accordingly, the Commission recommends that section 11(b)(2) be deleted from the Act, to bring the section in accord with current practices and standards.

C. MANAGEMENT-SHAREHOLDER RELATIONSHIPS

2. *Definition of investment adviser (see. 2(a)(19))*

Section 2(a)(19) of the Act, with certain exceptions, defines the term "investment adviser" to an investment company as any person who regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or is empowered to determine what securities or other property shall be purchased or sold by such company.

Section 2(a)(19) specifies a number of exceptions to this general definition of investment adviser, including one for a "bona fide officer, director, trustee, member of an advisory board or employee" of an investment company to which he is rendering advice. Section 15(a) of the Act prohibits "an investment adviser" from providing services to an investment company except pursuant to a written contract containing certain specified provisions. Among other things, the intent of this exception was to exclude managements and staffs of internally managed funds from the requirements of section 15(a). However, if read literally, section 2(a)(19) also exempts from the section 15(a) contract requirements a management organization which performs the same functions as an investment adviser simply because it is designated as trustee rather than as investment adviser.³⁰

In the Commission's view, there is no justification for permitting such a trustee to be exempt from the definition of an investment adviser and, therefore, from the contract requirements of the Act. Accordingly, it recommends that the definition of investment adviser in section 2(a)(19) of the Act be amended to limit to "natural persons" the exception from the definition for a "bona fide officer, director, trustee, member of an advisory board, or employee."

2. *Strengthening the independent checks on managements of investment companies (sees. 10, 15, and 32(a))*

Section 10 of the Act provides that at least 40 percent of the board of directors of a registered investment company must consist of persons who are neither officers nor employees of the company and who neither serve as, nor are affiliated with, its investment adviser. Section 10 also provides that if any officer, director, or employee of the investment company acts as, or is affiliated with, its principal underwriter or regular broker, a majority of the board must consist of persons other than those affiliated with such principal underwriter or regular broker.³¹ The function of these provisions with respect to

²⁹ Some of the series companies, as do other companies, charge a modest fee (generally \$5) for each transfer from one series to another. This practice will not be affected by the proposed amendment.

³⁰ At the present time this exception is applicable to only one investment adviser—Keystone Custodian Funds, Inc., the corporate trustee for 9 funds with combined assets of over \$1.1 billion as of June 30, 1996. Although Keystone Custodian Funds, Inc., is designated as trustee, it receives gross advisory and administrative fees for its services and its relationships to the funds no different from that of any other investment adviser to an externally managed fund.

³¹ Sec. 10 also provides that if any of the investment company's officers, directors, or employees are investment bankers or affiliated with investment bankers, a majority of the board must consist of persons who are neither investment bankers nor affiliated with investment bankers. This provision reflected Congressional concern over the dominant role of investment bankers and investment banking groups prior to 1940.

unaffiliated directors is to provide an independent check on management and to provide % means for representation of shareholder interests in investment company affairs.³²

The Act's definition of an "affiliated person"³³ does not provide an adequate test for this purpose. It permits a director who has strong ties with a company's investment adviser, principal underwriter or regular broker to be classified as an "unaffiliated director."³⁴ Under this definition, for example, a director is deemed to be "unaffiliated" even though he owns up to 4.99 percent of the adviser-underwrite stock, has substantial business or professional relationships with the investment company or its adviser-underwriter, or has close family relationships with the adviser-underwriter or with persons affiliated with it.

Under the existing definition of "affiliated person" it is possible to argue that these persons are not "unaffiliated" because they are "controlled" by the investment adviser, principal underwriter, or regular broker. Section 2(a)(9) of the Act which defines "control," states, however, that a "natural person shall be presumed not to be a controlled person within the meaning of this title." Although this presumption is rebuttable, in two recent cases the existence of strong economic ties has been determined by the courts to be insufficient evidence of control. Thus, in *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo., 1963), directors of Financial Industrial Fund, Inc., were held to be "unaffiliated" even though they either did a substantial amount of printing work for the fund, owned 4 percent of the outstanding stock of the fund's adviser-underwriter, acted as broker in a number of the fund's portfolio transactions, received give-ups of brokerage commissions from fund portfolio transactions or sold insurance to both the adviser-underwriter and the fund.

Similarly, in *Coran v. Thorpe*, 203 A. 2d 620 (Del. Chan., 1964) five directors of Atomic, Physics and Science Fund, Inc.,³⁵ were held to be unaffiliated with the investment adviser. One of the directors was a partner of a brokerage firm which previously had acted as investment adviser to the fund and was receiving a substantial amount of brokerage commissions from fund portfolio transactions. Another director was a salaried employee of the same brokerage firm. Still another director was a partner of another brokerage firm which executed portfolio transactions for the fund. Of the two remaining unaffiliated directors, one was the president and major stockholder of a consulting firm which previously had been retained by the fund to provide technical advice at substantial fees, while the other was a geologist employed by a subcontractor of the consulting firm.

³² Rouse Hearings, p. 109.

³³ Sec. 2(a)(3).

³⁴ This definition states:

"Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 percentum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof, and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

³⁵ The name of this investment company has been changed to Steadman Science & Growth Fund.

Regardless of whether the economic ties of the fund directors involved in these cases were sufficient to demonstrate that they were "controlled" by the investment adviser, principal underwriter, or regular broker, such close relationships derogate from directors' ability to represent effectively the interests of shareholders. In the Commission's view the disinterested representation of shareholders in the management of investment companies constitutes an important investor protection, even though, as the Act is now written, unaffiliated directors are not in a position to deal effectively in the areas of management compensation, allocation of brokerage, and the setting of sales load levels.³⁶ In these areas other steps, such as proposed by the Commission, are the sine qua non of adequate protection of investment company shareholders.

Nevertheless, if unaffiliated directors are to serve an important function in representing the interests of shareholders in investment company affairs, those directors should not be persons with economic or family relationships with management which are inconsistent with the independent role in investment company affairs that the Act contemplates they should play. The Commission believes, however, that the steps to be taken to strengthen the disinterestedness of investment company directors should avoid complicating the administration of other provisions of the Act, particularly the provisions of section 17, which prohibit not only transactions between investment companies and affiliated persons but also transactions between investment companies and affiliated persons of their affiliated persons. Accordingly, the Commission recommends that a new term be added to section 2 of the Act—"interested person"—which would be made applicable by appropriate amendments only to the provisions of section 10 relating to the composition of boards of directors, section 15 relating to the approval of advisory and underwriting contracts by a vote of a majority of unaffiliated directors, and section 32(a) relating to selection of independent public accountants.

While the general exemptive authority conferred on the Commission by section 6(c) of the Act would be available to permit flexibility in the administration of the requirements for disinterestedness, the statutory definition of an "interested person" should include:

(1) Any affiliated person (which includes an investment adviser), principal underwriter, and regular broker to an investment company, except where the affiliation arises solely by reason of his being a director of such investment company;

(2) Any member of the immediate family of such persons and affiliated persons of such persons; and

(3) Any person who (a) directly or indirectly owns securities issued by affiliated persons; or (b) has, or has had within the past 3 years, any material business or professional relationship with affiliated persons and their affiliated persons.

3. Attendance at directors' meetings (secs. 15 and 32)

Sections 15(a), 15(c) and 32(a) of the Act provide for (a) renewal of advisory contracts, (b) approval and renewal of underwriting contracts, and (c) the selection of independent auditors, respectively, by the board of directors of an investment company, including a majority of the unaffiliated directors. These sections, however, do

³⁶ Chs., III, IV, and V, *supra*.

not explicitly require the physical attendance of the members of the board of directors at meetings where required action is taken, even though their vote is necessary to meet the statutory requirements. The Commission has found that in some investment companies absentee approval by board members is not uncommon.

While this procedure may be permitted in some cases by State law, in the Commission's view, informed voting on the matters for which the Act mandates action by the board of directors can best be assured by providing expressly that the statutory requirements can be met only by a vote of a majority of directors present at the meetings at which such matters are voted upon. It therefore recommends that sections 15 and 32 be amended to provide that the voting requirements of these sections can only be satisfied by directors who are physically present at the meetings at which the votes are taken.³⁷

4. *Assignment of advisory and underwriting contracts (see. 15)*

Section 15(a)(4) requires that an investment advisory contract provide for automatic termination upon its "assignment by the investment adviser." Similarly, section 15(b)(2) requires that underwriting contracts provide for automatic termination upon their "assignment by such underwriter." However, section 2(a)(4) defines the term "assignment" for purposes of the Act to include action by persons other than the investment adviser or underwriter. Thus, under this definition, assignment includes any direct or indirect transfer of a controlling block of outstanding voting securities by a security holder of the adviser or underwriter.

While this result flows from the express terms of section 2(a)(4), it nevertheless has been argued that section 15 of the Act does not contemplate this result because, unlike section 2(a)(4), it does not expressly refer to transfers by persons other than the adviser or underwriter. However, section 15 is the only other section in the Act where the term "assignment" is used. If this argument were accepted, then the specific reference to transfers by controlling persons in section 2(a)(4) would be superfluous. To remove this ambiguity, the Commission recommends that section 15(a)(4) be amended to delete the words "by the investment adviser" and that section 15(b)(2) be amended to delete the words "by such underwriter."

5. *Section 17(f)*

Under section 17(f), an investment company of the management type must place "its securities and similar investments" in the custody of (1) a bank, (2) of a stock exchange firm subject to rules prescribed by the Commission, or (3) itself subject to rules or orders prescribed by the Commission. If a company chooses to retain the custody of its securities, it must deposit them with certain specified institutions for safekeeping, subject to certain rules as to access, earmarking and inspection.

³⁷ Where advisory or underwriting contracts lapse due to failure of directors to meet the proposed physical attendance requirements because of physical impossibility or other justifiable inadvertence, the Commission could permit the extension of already-existing contracts by order under sec. 6(c) of the Act. In an analogous situation, the Commission has not objected in certain cases when directors of an investment company served for more than a year because of justifiable postponement of the company's annual shareholders' meeting, despite the requirement of sec. 16(a) that directors of an investment company be elected annually.

The Commission believes that if a company wishes to use a bank as custodian, all of its cash assets, including proceeds from the sale of its own securities and income on its holdings, also should be held by a bank subject to appropriate direction as to expenditure and disposition by proper company officials.³⁸

Accordingly, the Commission recommends amending section 17(f) to provide that if an investment company employs a bank as custodian, **all** cash assets in addition to "securities and similar investments" shall likewise be kept in such custody. A proviso in the amendment would permit the maintenance of a checking account or accounts in one or more banks in an amount not to exceed the fidelity bond required under section 17(g) of the Act.

6. Section 25(c)

Section 25(c) of the Act authorizes any district court of the United States upon proceedings instituted by the Commission, to "enjoin the consummation of any plan of reorganization"³⁹ of a registered investment company, "if such court shall determine any such plan to be grossly unfair or to constitute gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of such registered company or other sponsors of such plan."

The reorganization of an investment company usually is an event of paramount importance to its public security holders. Plans of reorganization, however, often are so complex that it is difficult for shareholders to assess their impact or to evaluate their fairness. Moreover, shareholders rarely are in a position to effect changes in a plan proposed by management.

Prior to 1940 there were widespread abuses in investment company reorganizations. Indeed, former Commissioner Healy stated, "I don't think that there has been any place in the whole list of American finance where there has been more mistreatment of American security holders than in this one field of reorganization."⁴⁰ Nevertheless, the existing provisions of section 25(c) permit a court to enjoin consummation of a reorganization plan only if it finds that the plan is "grossly unfair" or that the plan constitutes "gross misconduct" or "gross abuse of trust" on the part of officers, directors, investment advisers or other sponsors of the plan. The original draft of this section provided in effect that no voluntary plan of reorganization could be submitted to shareholders without Commission approval. The section also contained guidelines for such approval, one of which was that the plan or offer must be "fair and equitable to all persons affected * * *."⁴¹ This met with strenuous industry objections and was therefore deleted even though the section followed the pattern of the Holding Company Act. However, the industry objection was not directed at the standards. Rather, it was concerned with the fact that all plans would have to be submitted to, and approved by, the Commission.⁴² To meet such objections, a compromise section was agreed upon by the Commission and representatives of the industry which gave courts the power of disapproval of such plans of reorganization.

³⁸ Some States insist upon this complete bank custodianship as a prerequisite to the sale of securities within the State.

³⁹ Reorganization is defined in sec. 2(a)(32) of the Act.

⁴⁰ House Hearings at p. 128.

⁴¹ S. 3580, 76 Cong., 3d sess. (1940), sec. 25(d)(1).

⁴² See discussion by Alfred Jaretzki, Jr., at p. 127 of the House Hearings.

The Commission believes that the standard presently in the Act unduly restricts courts from passing upon the merits of a plan of reorganization of a registered investment company. If courts were given a more realistic standard to apply, especially one employed in similar contexts? they would be in a better position to carry out the Congressional intent of protecting the security holders of the investment company for which the plan of reorganization was filed. Therefore, the Commission recommends that Congress amend section 25(e) of the Act to provide that a court shall enjoin any plan of reorganization which it finds not to be "fair and equitable" to all persons affected. The "fair and equitable" standard has a long history of judicial interpretation in equity receiverships and reorganizations under section 77B and Chapter X of the Bankruptcy Act and section 11(e) of the Public Utility Holding Company Act of 1935. Accordingly, this amendment would provide the courts with a well known and judicially acceptable standard to protect shareholders' rights.

7. *Substitution of underlying investment (sec. 26(a)(4))*

As more fully described in Chapter II, a "unit investment trust" is an investment company which usually purchases shares of an open-end management investment company and in turn sells its own redeemable securities which represent undivided interests in the shares of the open-end company. Section 26(a)(4)(B) of the Act provides that if there is a substitution of the underlying investment of the unit investment trust, the sponsor must notify the shareholders of the unit investment trust within 5 days after the change.

As a practical matter, security holders in a unit investment trust are seldom in a position to judge the merits of the substituted security. Furthermore, if the only action required by the sponsor were notification of shareholders, their only relief, if dissatisfied, would be to redeem their shares. In doing this they might incur a substantial loss because of the large initial sales load deduction that is common to most unit investment trusts; and if they reinvest the proceeds in another unit investment trust or in an open-end company directly they may be subject to an additional sales load.

Section 11(e) of the Act provides that Commission approval must be obtained for the exchange of securities of one registered unit investment trust for the securities of another registered unit investment trust, irrespective of the basis of exchange.⁴³ The Commission has taken the position that a substitution of the underlying securities of a unit investment trust is an "offer of exchange" under section 11 of the Act and is prohibited unless exempted by the Commission. However? the Commission believes that the matter should be expressly covered under section 26, which is concerned with the operations of unit investment trusts under the Act.

Accordingly, the Commission recommends that section 26 be amended to require that proposed substitutions may not occur without Commission approval. Not only would there be Commission scrutiny, but interested shareholders would also have an opportunity to state their views about the proposed substitution. Before issuing an order approving the substitution, the Commission would be required to find that the substitution is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

⁴³ See *Hamilton Depositors Corp. et al.*, 25 S.E.C. 141 (1947).

8. *Shareholder derivative suits (sec. 33)*

Section 33 of the Act requires registered investment companies and their affiliated persons who are defendants in shareholders derivative suits involving "an alleged breach of official duty" to transmit to the Commission copies of the pleadings and the record in such actions if the action has been compromised or settled or a verdict or final judgment has been rendered on the merits. These provisions do not require that the Commission be informed of such actions until they have terminated at the trial court level. Then it may be too late for the Commission to take action to protect the public interest.

In chapter III the Commission has proposed that the Act be amended to permit the Commission to intervene in shareholder suits brought to enforce the legislative recommendations made in that chapter at any stage in the proceeding or in the settlement of such actions.⁴⁴ To provide the Commission with the information necessary to fulfill its responsibilities under the Act, the Commission also recommends that section 33 of the Act be amended to require that all papers filed in shareholder suits involving registered investment companies be transmitted promptly to the Commission.

D. ADMINISTRATIVE AND OTHER PROCEEDINGS

1. *Section 9*

Section 9(a) of the Act prohibits any person from serving in certain capacities⁴⁵ with a registered investment company if he has been convicted of any of the crimes set forth in section 9(a)(1) or has been permanently or temporarily enjoined by a court for other misconduct as set forth in section 9(a)(2). Section 9(b) provides for exemption from the prohibition if the Commission, upon application, finds the prohibition is unduly severe or that the person's conduct was such that granting the application would not be against the public interest or protection of investors.

Section 9 to some extent is the counterpart to the provisions of section 203(d) of the Investment Advisers Act, and section 15(b) of the Exchange Act which, among other things, empower the Commission to disqualify persons who have committed certain types of misconduct from serving as a registered investment adviser or broker-dealer or as an associated person of a broker-dealer. In several respects, however, section 9 affords investment company shareholders far less protection than those provided customers and clients of investment advisers by the Investment Advisers Act and of broker-dealers by the Exchange Act.

Under the latter statutes, willful violations of the Securities Act, Investment Advisers Act, Exchange Act, Investment Company Act, or any rule or regulation thereunder, are grounds for disqualifying a person from registration as an investment adviser or as a broker-dealer or an associated person of a broker-dealer. However, as noted

⁴⁴ Pp. 143-147 *supra*.

⁴⁵ The capacities, enumerated in the first paragraph of sec. 9(a), are officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company.

above, under section 9 a person is barred from serving in certain capacities with a registered investment company only if he has been convicted of certain crimes or has been enjoined by a court by reason of certain types of misconduct from acting as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman or employee of an investment company, bank or insurance company. Thus, if the Commission has found that an investment adviser or broker-dealer or an associated person thereof has violated the anti-fraud or other provisions of the Investment Advisers Act or Exchange Act and has barred him from serving as an investment adviser or broker-dealer or from association with a broker-dealer, section 9 nevertheless does not prevent him from occupying a position of responsibility with an investment company.

Moreover, unlike the provisions of section 15(b) of the Exchange Act and section 203(d) of the Investment Advisers Act, section 9 has no provision for an administrative proceeding to determine whether persons have engaged in willful misconduct and whether the public interest requires that such persons be barred from serving an investment company. Unless a court has already convicted or enjoined a person in one of the areas specified in section 9, the Commission must apply to a court for an injunction against the misconduct in-order to bar him from serving an investment company. There is no reason why the Commission should not have administrative remedies under the Investment Company Act similar to those in the Investment Advisers Act and the Exchange Act.

Section 9 is deficient in another respect. Although it bars a person convicted of crimes or enjoined on the basis of misconduct specified in that section from serving as an officer, director, or investment adviser of an investment company, such a person may still be an employee of an investment company.

Accordingly, the Commission recommends that section 9 be amended to include a new subsection which would empower the Commission, after notice and opportunity for hearing, to bar an individual either permanently or for such time as may be appropriate from serving an investment company in the capacities now enumerated in section 9, or as an employee of an investment company or as an affiliated person of its investment adviser, depositor or principal underwriter if such individual has willfully violated any provision of the Securities Act, the Exchange Act, the Investment Advisers Act, or the Investment Company Act or any rule or regulation thereunder. These amendments would enable the Commission to deal flexibly in protecting investment company shareholders against management of their companies' assets by persons who have engaged in willful misconduct under the Federal securities laws.

In appropriate cases, the Commission could take action against an individual affiliated with a company's investment adviser, principal underwriter, depositor, or sponsor without naming or joining the adviser, underwriter, depositor, or sponsor as a party in such action. By providing an administrative proceeding for determining whether a person should be barred from serving an investment company, the Commission could, where appropriate, institute private proceedings which would not be made public unless and until adverse findings were made against the individual or company involved.⁴⁶

⁴⁶ Under sec. 41 of the Act, the Commission is empowered to hold private administrative proceedings.

In appropriate cases, a proceeding to bar a person from serving an investment company under section 9 because of violations of provisions of other Federal securities laws could be combined with proceedings under the Investment Advisers Act and the Exchange Act. In such a combined proceeding, the Commission could determine whether a person should be barred from associating with a broker-dealer registered under the Exchange Act, an adviser registered under the Investment Advisers Act, or an investment company or adviser to an investment company registered under the Investment Company Act. Such an amendment will provide investment company shareholders with protections comparable to those which customers of registered broker-dealers and clients of registered investment advisers now enjoy under provisions of the Exchange Act and as proposed under the Investment Advisers Act."

2. Section 36

Section 36 specifically authorizes the Commission to bring actions in U.S. district courts to enjoin any officer, director, advisory board member, investment adviser, depositor, or principal underwriter of investment companies from acting in such capacities if such a person has been "guilty" of "gross misconduct" or "gross abuse of trust" with respect to the investment company which he serves. Section 36 is an exceedingly important provision of the Act, since it was intended to permit the Commission to enforce standards of fiduciary conduct which may not be embodied in other, more specific provisions of the Act.

However, the highly personal and punitive overtones of the section 36 language create problems in enforcing the remedial purposes of the Act. The express sanction in section 36 is seemingly directed more against persons "guilty" of misconduct than the prevention of injury to an investment company. This may be due to the fact, that it was originally drafted as a criminal provision.⁴⁸ Under the literal terms of section 36 an injunction against conduct harmful to the company is only discretionary relief ancillary to a bar against the wrongdoers from continuing to serve in their capacity with an investment company. The bar, however, is not discretionary. If a court finds that one is "guilty" of "gross misconduct" or "gross abuse of trust," section 36 provides that the court "shall" bar him temporarily or permanently from acting in any of the capacities enumerated in that section. The mandatory sanction of section 36 and the stigma that attaches to a finding of "gross abuse of trust" tends to make action under section 36 an unduly harsh remedy for some types of misconduct encountered by the Commission in the administration of the Act. Yet at the present time the Act does not provide a more flexible means for protecting the interest of investment company shareholders.⁴⁹ Under the antifraud provisions of the Exchange Act and the Investment Advisers Act, the Commission has broad power to deal flexibly with the misconduct of broker-dealers and in-

⁴⁸ See pp. 343-344, *infra*

⁴⁸ 6,3580; secs. 17(e) and 43, Senate Report, pp. 12 and 26. See also Senate Report p. 262.

⁴⁹ *Cf. S.E.C. v. Midwest Technical Development Corporation*, CCH Fed. Sec. L. Rep., par. 91,252, D.C. Minn. 4th Div., No. 4-62, Civ. 142 (1963).

vestment advisers in dealings with their clients.⁵⁰ There is no reason why the Commission should not have comparable power with respect to all affiliated persons of investment companies who certainly occupy no less a position of trust than do broker-dealers or investment advisers to noninvestment company clients.

For these reasons the Commission recommends that section 36 be amended to delete the words "gross" and "guilty" and broaden the statutory relief under that section beyond that of disciplinary sanctions. The amendment would authorize the Commission to seek injunctions in Federal courts against any act, practice or course of conduct which involves a breach of fiduciary duty on the part of any of the persons now enumerated in that section with respect to any investment company which they serve and to seek such other relief as the court may deem necessary or appropriate for the protection of investors. Under the proposed amendment, the Commission could apply to the U.S. district courts to enjoin a breach of fiduciary duty in the same manner as it can seek injunctions against violations of specific provisions of the Act and, in addition, it could obtain such ancillary relief, including restitution and such other relief as the court deems appropriate. The Commission believes that this amendment would make section 36 a far better vehicle than it now is for defining and enforcing fiduciary standards of conduct by persons affiliated with investment companies. In addition, it would complement the proposed amendments to section 9 which would provide for administrative proceedings to bar or remove persons from acting in certain capacities for an investment company.

E. FORMAL

The amendments discussed under this category are concerned mainly with correcting outdated references and patent ambiguities in the text of the Act.

1. Section 2(a)(5)

In section 2(a)(5) of the Act a reference is made to section 11(k) of the Federal Reserve Act, as amended. Section 11(k) of the Federal Reserve Act has been repealed,⁵¹ and as a result the authority granted by this section over banks formerly exercised by the Federal Reserve Board is now exercised by the Comptroller of the Currency. It is therefore proposed that the words "authority of the Comptroller of the Currency" be substituted for the words "section 11(k) of the Federal Reserve Act, as amended."

2. Section 3(c)

Section 3(c) of the Act excludes certain categories of companies from the definition of an investment company found in subsections (a) and (b) of section 3. However, since only subsection (a) defines an investment company, the reference to subsection (b) in section 3(c) is superfluous. Therefore, the Commission recommends the deletion of such reference.

⁵⁰ Exchange Act, secs. 10, 15; Investment Advisers Act, sec. 206.

⁵¹ Public Law No. 87-722, Sept. 28, 1962, 76 Stat. 670.

3. Section 3(c)(13)

In section 3(c)(13) an exception is provided for an employees' stock bonus, pension, or profit sharing trust which qualifies under section 165 of the Internal Revenue Code, as amended. Section 165 was replaced by section 401(a) when the Internal Revenue Code was revised in 1954. Therefore, the Commission recommends that section 3(c)(13) be amended to make the appropriate substitution.

4. Section 10(c)

Section 10(c) of the Act prohibits a registered investment company from having a majority of its board of directors consist of officers or directors of any one bank. The second clause provides a limited exception from the prohibition for any registered investment company which on March 14, 1940, had as a majority of its board of directors, the officers, directors or employees of any one bank. While the first clause does not include employees, the second clause includes them. There does not appear to be any reason for this inconsistency except oversight. Therefore, the Commission suggests an amendment adding the word "employee" to the first clause of section 10(c).

5. Section 15(d)

Section 15(d) prohibits any person from acting as investment adviser to, or principal underwriter for, any registered investment company pursuant to a written contract after March 15, 1945, if such contract was in effect prior to March 15, 1940, unless such contract was renewed prior to March 15, 1945, in such form as to make it comply with sections 15(a) or 15(b) of the Act. The times mentioned in section 15(d) have long since passed and the section no longer has any meaning or applicability, since there are no persons who are, or ever will be, affected by the section. Therefore, the Commission proposes that section 15(d) be deleted from the Act.

6. Section 22(d)

Section 22(d) of the Act provides, in relevant part, that it shall not prevent a sale made "pursuant to an offer of exchange permitted by section 11 hereof including any offer made pursuant to clause (1) or (2) of section 11(b)." As noted previously, the Commission recommends that clause (2) of section 11(b) of the Act be deleted. Therefore, the Commission suggests that section 22(d) of the Act be amended to conform with the suggested amendment to section 11(b) of the Act by deleting the reference to clause (2) of section 11(b) of the Act in section 22(d) of the Act.

7. Section 24(d)

Among other things, section 24(d) of the Act states that the exemption provided by the third clause of section 4(1) of the Securities Act of 1933 shall not apply to face-amount certificate companies, open-end management companies or unit investment trusts. In 1964, the Securities Act of 1933 was amended⁵² and the third clause of section 4(1) became section 4(3). To correct this statutory cross-reference, the Commission recommends that section 24(d) of the Act be amended to refer to section 4(3) of the Securities Act of 1933.

⁵² 15 U.S.C. 77(d), 48 Stat. 77, amended by Public Law No. 84-467.

8. *Section 38(a)*

Section 38(a) of the Act empowers the Commission to make such rules and regulations as are necessary or appropriate "to the exercise of the powers conferred upon the Commission elsewhere in this title." The language conferring rulemaking power upon the Commission in the Act is not consistent with the language of similar provisions in other securities acts⁵³ which gives the Commission broad rule-making authority regarding the statutes it administers. The Commission recommends that Congress amend the Act so that the language conferring rulemaking powers thereunder would be the same as the language in the Public Utility Holding Company Act.⁵⁴

9. *Section 43(a) and section 44*

Section 43(a) of the Act provides for court review of Commission orders. This section refers to sections 239 and 240 of the Judicial Code. Those sections have been redesignated section 1254 of title 28 of the United States Code, as amended.⁵⁵ Similarly, section 44 of the Act, which gives the district courts of the United States jurisdiction of violations of the Act or rules and regulations, thereunder, refers to sections 128 and 240 of the Judicial Code, as amended. Those sections have been redesignated as sections 1254 and 1291-1294 of title 28 of the United States Code.⁵⁶ The Commission recommends that both statutory cross-references be amended to conform with the present designation of these sections.

F. INVESTMENT ADVISERS ACT

The Commission's experience in administering the Investment Advisers Act has also revealed certain shortcomings in that statute. Accordingly, the Commission recommends the following amendments to the Investment Advisers Act.

1. *Direct disciplinary power over individuals (sec. 203)*

Section 203(d) of the Investment Advisers Act empowers the Commission, after notice and opportunity for hearing, to deny registration to or to suspend or revoke the registration of an investment adviser if it finds that such action is in the public interest, and that the adviser or any of its partners or officers or directors is subject to an injunction or has been convicted or committed any act or omission specified in that section. Under these provisions, however, if a person affiliated with a registered investment adviser violates the law, the Commission can take disciplinary action against such person only by proceeding against the adviser even if the misconduct occurred without the knowledge or approval of the adviser. Since such action may involve persons wholly innocent of any responsibility for the violations in question, this procedure is awkward and may be unfair.

Under the Exchange Act, the Commission has been granted the authority to take direct disciplinary action against individuals asso-

⁵³ See sec. 19(a), Securities Act of 1933; sec. 23(a), Securities Exchange Act of 1934; sec. 20(a), Public Utility Holding Company Act of 1935; sec. 319(a), Trust Indenture Act of 1939.

⁵⁴ Sec. 20(a) of the Public Utility Holding Company Act provides, in relevant part:

"The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it may deem necessary or appropriate to carry out the provisions of this title, including rules and regulations defining accounting, technical, and trade terms used in this title."

⁵⁵ 28 U.S.C. 1254, 62 Stat. 928 (1948).

⁵⁶ *Ibid.*; 28 U.S.C. 1291-1294, 62 Stat. 929-930 (1948).

ciated with registered broker-dealers. The Securities Acts Amendments of 1964, among other things, added section 15(b)(7) to the Exchange Act which empowers the Commission to issue an order barring or suspending the right of an individual guilty of misconduct from being associated with a registered broker-dealer. The Commission believes that comparable flexibility is desirable in the administration of the Investment Advisers Act. Accordingly, it recommends that a new paragraph (h) be added to section 203 of the Investment Advisers Act which would authorize the Commission to proceed directly against a person and to censure, bar, or suspend the right of such person to be affiliated with a registered investment adviser, if such person is subject to an injunction or conviction or has committed any act or omission which would be a basis for revocation if such person were an investment adviser. The statutory disqualification would not be automatic but would require a finding by the Commission that it is in the public interest.

Under the proposed amendment, the Commission would have the discretion to proceed against a person without joining an investment adviser with whom such person or persons may have been affiliated. Alternatively, in appropriate cases where an economy of proceedings would result, an investment adviser and other appropriate persons could be joined in the same action. The amendment would also make it unlawful for any person, as to whom a barring or suspension order is in effect, willfully to become or to be affiliated with an investment adviser without the Commission's consent. It would also be unlawful for the investment adviser to allow such a person to become affiliated with the investment adviser if it knew, or in the exercise of reasonable care, should have known, of such order.

2. Amendment of definition of investment adviser (secs. 203(b)(2), 203(b)(3) and 205)

Section 203(b)(2) of the Investment Advisers Act provides an exception from registration under that Act for any investment adviser whose only clients are investment companies and insurance companies. Section 203(b)(3) provides a similar exception for an investment adviser who had fewer than fifteen clients during the preceding twelve months and who does not hold himself out generally to the public as an investment adviser. Also, section 205 of that Act excludes investment advisory contracts with investment companies from the coverage of such Act. Accordingly, most investment advisers of investment companies, as defined in section 2(a)(19) of the Investment Company Act, are exempt from the registration provisions of the Investment Advisers Act.⁵⁷ Therefore, the Commission recommends that the Investment Advisers Act be amended to remove the exemption for investment advisers to investment companies.

Under section 31(a) of the Investment Company Act, every investment adviser of a registered investment company is required to maintain and preserve "such accounts, **books**, and other documents as are necessary or appropriate to record such person's transactions with such registered investment company." The proposed amendment of the Investment Advisers Act will complement section 31(a)

⁵⁷ The exemption does not run to the antifraud provisions of sec. 206 of the Investment Advisers Act. p. 63, *supra*.

in that investment advisers to registered investment companies will be required to maintain books and records under the Investment Advisers Act reflecting all activities of the investment adviser.⁵⁸

It should be noted that the Investment Advisers Act provides that no registered investment adviser shall be a party to any investment advisory contract if such contract provides for compensation on the basis of a share of capital gains or capital appreciation of the funds of the client.⁵⁹ The proposed amendment of the Investment Advisers Act will also subject investment advisory contracts between an adviser and a registered investment company to this prohibition. This restriction was originally contemplated in the initial bill which became the Investment Advisers Act. The bill did not exclude investment advisers to investment companies and it contained the present prohibition against compensation based upon capital gains and appreciation.⁶⁰

This amendment would complement the Commission's recommendations in chapter III that the Investment Company Act be amended to incorporate a standard of reasonableness for compensation paid by investment companies for services furnished by those who occupy a fiduciary relationship to such companies.⁶¹ Thus, under the proposed amendments to the Investment Advisers Act, capital gains and appreciation of a registered investment company could be taken into account as a factor in setting the amount of the fee of its investment adviser, but such fee could not be tied directly to such gains or appreciation.

3. Administrative exemptions from the provisions of the Investment Advisers Act

As noted in chapter II, when the Investment Company Act was under consideration it was recognized that there would be companies which would fall under the broad basic definitions of an investment company in that Act and would not come within any of the specific exclusions in the Act, but which nevertheless presented peculiar situations rendering it unnecessary or unwise to treat them as investment companies for some or all purposes of the Act.⁶² To permit the individualized treatment called for in these and other situations and to avoid undue rigidity in the administration of the Investment Company Act, the specific statutory exclusions were supplemented by vesting in the Commission the broad exemptive powers set forth in section 6(c).

⁵⁸ Rule 204-2 under the Investment Advisers Act.

⁵⁹ The relevant part of sec. 205 provides that no investment adviser shall be a party to any investment advisory contract if such contract:

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

“Paragraph (1) of this section shall not be construed to prohibit an investment advisory contract which provides for compensation based upon the total value of the fund averaged over a definite period or as of definite dates, or taken as of a definite date.”

As noted above, sec. 205 excludes investment advisers to investment companies from the prohibition.

⁶⁰ See secs. 204 and 205 of S. 3580 on pp. 30 and 31 of Senate Hearings. The Senate Report on S. 3660 said: “Individuals assuming to act as investment advisers at present can enter profit-sharing contracts which are nothing more than ‘heads I win, tails YOU lose’ arrangements.” (S. Rept. No. 1775, 76th Cong., 3d sess. (1940) at p. 22).

⁶¹ Pp. 143-149, supra.

⁶² P. 37, supra.

The Commission has concluded that similar administrative flexibility would be desirable in connection with its administration of the Investment Advisers Act to complement the broadened coverage and additional remedies proposed previously in this chapter. Therefore, the Commission recommends that a new section be added to the Investment Advisers Act giving the Commission authority by rules and regulations, upon its own motion or by order, upon application, conditionally or unconditionally to exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of the Investment Advisers Act or of any rule or regulation thereunder, if and to the extent that the Commission finds that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

4. Jurisdictional requirement

At present, various provisions of the Investment Advisers Act apply only to activities which involve a use of the mails or means or instrumentalities of interstate commerce. For example, the anti-fraud provisions of section 206 prohibit certain fraudulent and deceptive acts, practices, and courses of business by investment advisers, whether registered or not, when the mails or means or instrumentalities of interstate commerce are used.

The Commission recommends that the Investment Advisers Act be amended to include a section similar to section 15(b)(4) of the Exchange Act providing that sections of the Investment Advisers Act (other than sec. 203(a)) which prohibit any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used, would also prohibit such activities by any investment adviser registered under section 203(a), or any person acting on behalf of such an investment adviser, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

A use of the mails or means or instrumentalities of interstate commerce originally was considered necessary in order to furnish a constitutional basis for Federal regulation. At the time that section 15(b)(4) was added to the Exchange Act, however, judicial decisions had made clear that the act of registration furnishes a sufficient constitutional basis for Federal regulation. Since the Investment Advisers Act provides that no investment adviser is required to register unless he uses the mails or instrumentalities of interstate commerce in connection with his business, the constitutional foundation for regulation remains the same. Eliminating the necessity of establishing a use of the mails or means or instrumentalities of interstate commerce in cases under the Investment Advisers Act ~~+~~ obviate time-consuming searches for evidence which has no bearing on the substance of a case.