

INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT
ADVISERS ACT OF 1940

JUNE 18, 1940.—Committed to the Committee of the Whole House on the state of
the Union and ordered to be printed

Mr. COLE of Maryland, from the Committee on Interstate and
Foreign Commerce, submitted the following

R E P O R T

[To accompany H.R. 10065]

The Committee on Interstate and Foreign Commerce to whom was referred the bill (H. R. 10065) to provide for the registration and regulation of investment companies and investment advisers, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

The amendments are as follows:

Page 12, line 9, strike out "prescribed" and insert in lieu thereof "described".

Page 19, line 2, after the word "securities", insert "or the issuer thereof".

Page 20, line 3, strike out all the line and insert in lieu thereof:

so determined is not in excess of market value of asset value of such securities in the case of majority-owned subsidiaries, and is not in excess of market value in the case of other controlled companies.

Page 31, after line 23, insert a new paragraph as follows:

- (2) Any company which since the effective date of this title or within five years prior to such date has been reorganized under the supervision of a court of competent jurisdiction, if (A) such company was not an investment company at the commencement of such reorganization proceedings, (B) at the conclusion of such proceedings all outstanding securities of such company were owned by creditors of such company or by persons to whom such securities were issued on account of such company or by persons to whom such securities were issued on account of creditors' claims, and (C) more than 50 per centum of the voting securities of such company, and securities representing more than 50 per centum of the net asset value of such company, are currently owned beneficially by not more than 25 persons; but such exemption shall terminate if any security of which such company is the issuer is offered for sale or sold to the public after the conclusion of such proceedings by the issuer or by or through any underwriter. For the purposes of this paragraph, any new company organized as part of the reorganization shall be deemed the same company as its predecessor; and beneficial ownership shall be determined in the manner provided in section 3 (c) (1).

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Page 31, line 24, change “(3)” to “(4)”.

Page 33, after line 16, insert a new paragraph as follows:

(d) The Commission, by rules and regulations or order, shall exempt a closed-end investment company from any or all provisions of this title, but subject to such terms and conditions as may be necessary or appropriate in the public interest or for the protection of investors, if—

- (1) the aggregate sums received by such company from the sale of all its outstanding securities, plus the aggregate offering price of all securities of which such company is the issuer and which it proposes to offer for sale, does not exceed \$100,000;
- (2) no security of which such company is the issuer has been or is proposed to be sold by such company or any underwriter therefor, in connection with a public offering, to any person who is not a resident of the State under the laws of which such company is organized or otherwise created; and
- (3) such exemption is not contrary to the public interest or inconsistent with the protection of investors.

Page 33, line 17, change “(d)” to “(e)”.

Page 46, after line 7, strike out all of lines 8, 9, 10, and 11 and in lieu thereof insert the following:

(2) such investment adviser is registered under title II of this Act and such investment adviser is engaged principally in no business other than that of rendering investment supervisory services as defined in title II;

Page 56, line 2, after “of”, strike out “only”.

Page 56, line 2, after “stock”, insert “only”.

Page 56, line 22, after “company”, insert “and any company or companies controlled by such registered company”

Page 57, strike out all of line 14 and in lieu thereof insert the following:

or any State, or to affect the right under State law of any insurance company to acquire securities of any other insurance company or insurance companies. Page 71, line 20, after “place”, insert “and maintain”.

Page 72, strike out all of lines 1 to 14, inclusive, and in lieu thereof insert the following: subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investors; or (3) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors. Rules, regulations, and orders of the Commission under this subsection, among other things, may make appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of such securities and investments, and may provide for or require periodic or other inspections by any or all of the following: Independent public accountants, employees and agents of the Commission, and such other persons as the Commission may designate. No such member which trades in securities for its own account may act as custodian except in accordance with rules and regulations prescribed by the Commission for the protection of investors.

Page 93, line 3, after the period at the end of the line, insert a new sentence as follows: Any company which, as of March 15, 1940, was required by provision of its charter, certificate of incorporation, articles of association, or trust indenture, or of a bylaw or regulation duly adopted thereunder, to postpone the date of payment or satisfaction upon redemption of redeemable securities issued by it, shall be exempt from the requirements of this subsection; but such exemption shall terminate upon the expiration of one year from the effective date of this title, or upon the repeal or amendment of such provision, or upon the sale by such company after March 15, 1940, of any security (other than short-term paper) of which it is the issuer, whichever first occurs.

Page 93, strike out all of lines 12, 13, and 14 and in lieu thereof insert the following:

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(g) No registered open-end company shall issue any of its securities (1) for services; or (2) for property other than cash or securities (including securities of which such registered company is the issuer), except as a dividend or distribution to its security holders or in connection with a reorganization.

Page 93, strike out all of lines 17, 18, and 19 and in lieu thereof insert the following:
SEC. 23. (a) No registered closed-end company shall issue any of its securities (1) for services; or (2) for property other than cash or securities (including securities of which such registered company is the issuer), except as a dividend or destruction to its security holders or in connection with a reorganization.

Page 93, line 23, after "which", strike out "price" and insert in lieu thereof "net asset value".

Page 93, line 24, after "determined", strike out "on the basis of values calculated".
Page 94, line 4, after "its", strike out "common-stock holders" and insert "common stockholders".

Page 96, line 1, after "commerce," strike out "or" and insert "to".

Page 98, strike out the word "opinion" and insert in lieu thereof the word "report" in lines 2, 6, 7, 9, 17, 19, 21, and 23.

Page 103, line 21, after "investment", strike out "company, or" and insert in lieu thereof "company issuing periodic payment plan certificates, or".

Page 103, line 22, after "any", strike out "periodic payment plan" and insert "such".
Page 105, line 19, strike out "company, or" and in lieu thereof insert "company issuing periodic payment plan certificate, or".

Page 105, line 20, after "any", strike out "periodic payment plan" and insert "such".

Page 108, line 5, after "the", strike out "specified".

Page 108, line 17, after "minimum rate", insert a comma.

Page 108, line 18, after "of", strike out the comma and "the nearest".

Page 109, line 16, after "holder", strike out "under the terms of his certificate".

Page 110, lines 9 and 10, strike out "under the terms of his certificate".

Page 110, line 10, after "of", strike out "a" and insert "any".

Page 120, line 19, after "Sec. 29.", insert "(a)".

Page 121, line 2, strike out the figures "45" and insert the figure "2".

Page 121, line 23, strike out "October 1, 1940" and insert in lieu thereof "January 1, 1941".

Page 124, line 20, after "section", insert "13 or".

Page 130, line 1, strike out "such holders" and in lieu thereof insert "stockholders".

Page 130, line 13, change the period at the end of the line to a colon. Page 130, after line 13, insert the following:

Provided, That if the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3) the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or if not so filled then at a subsequent meeting which shall be called for the purpose.

Page 130, line 22, after the end of the line, insert the following:

In the event of such termination and removal the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial

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interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian, or if not so filled within a reasonable time then at a subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph (40) of section 2 (a) as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection.

Page 149, line 4, after “misleading”, strike out the comma and insert “in the light of the circumstances under which they were made”.

Page 155, line 8, after “broker”, insert “or dealer”.

Page 155, line 10, strike out “brokerage” and after the word “business” insert “as a broker or dealer”.

Page 155, line 25, at the end of the line strike out “and” and insert “ ‘control’ and”.

Page 156, strike out all of lines 3, 4, and 5.

Page 156, line 6, strike out “(14)” and insert “(13)”.

Page 156, lines 8 to 12, inclusive, strike out the following:

For the purposes of this paragraph the term “continuous advice” shall mean at least a quarterly review by the investment adviser of the investments of the client entrusted to his supervision. Pages 156 and 157, renumber paragraphs (15), (16), (17), (18), (19), (20), and (21), respectively, to paragraphs (14), (15), (16), (17), (18), (19), and (20).

Page 162, strike out all of lines 5 and 6 and in lieu thereof insert the following:

- (2) A statement as to whether such investment adviser is engaged or is to engage primarily in the business of rendering investment supervisory services.

Page 165, strike out all after line 17 and in lieu thereof insert the following:

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

Page 166, strike out all after line 19 and in lieu thereof insert the following:

(c) It shall be 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.

This bill is substitute for H. R. 8935, introduced March 14, 1940, and as originally introduced was identical with S. 4108, reported favorably to the Senate on June 6, 1940, by its Committee on Banking and Currency. The Senate bill itself was a substitute for S. 3580, introduced March 14, 1940, as a companion bill to H. R. 8935.

These bills are the outgrowth of a comprehensive study and investigation of investment trusts and investment companies made by the Securities and Exchange Commission pursuant to the direction of the Congress. A subcommittee of the Senate Banking and Currency Committee held hearings on S. 3580 for a period of approximately 4 weeks

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and carefully and exhaustively scrutinized and explored all of its provisions. In its consideration of this bill, your committee had before it the complete testimony on the original Senate bill and the reports of the Securities and Exchange Commission. At the hearings before the Senate Committee on Banking and Currency the immediate need for national legislation regulating investment companies was admitted by virtually every

witness who testified, but objection was made to several features of the bill. At the conclusion of these hearings the investment companies who had appeared submitted to the Senate committee specific principles for the regulation of investment trusts and investment companies. Following the submission of these counterproposals for regulation by the investment companies themselves, representatives of the Securities and Exchange Commission and of the investment companies informed the Senate Committee on Banking and Currency that it might be possible for them to reconcile their differences and to recommend a bill which would be acceptable both to the Securities and Exchange Commission and to the investment-company industry.

As a result of this cooperative effort upon the part of the Securities and Exchange Commission and the representatives of the investment-company industry, this bill, H. R. 10065, and its companion bill in the Senate, S. 4108, were recommended. They represent the result of intensive effort for a period of 5 weeks by representatives of the industry and of the Commission.

The bill as drafted has the unqualified support and endorsement of practically the entire investment-company industry and of the Securities and Exchange Commission, the body by whom the provisions of the bill are to be administered. No opposition to the bill was expressed by any witness who appeared before the subcommittee of this committee which held hearings on the bill. Every witness representing the industry who appeared, unqualifiedly endorsed the bill.

Thus this bill is a highly salutary indication that Government and business can come together in a cooperative spirit to do a constructive job. Representatives of investment companies urge that the present international situation should not only not constitute an impediment to the passage of this bill but rather should serve as a vital reason for its immediate enactment.

These representatives of the investment-company industry stressed the fact that proper and reasonable regulation of investment companies may substantially stimulate investment companies to supply new capital for the expansion of industry, particularly industries vital to the national defense, to a far greater extent than has been done in the past. To accelerate this activity upon the part of investment companies the bill expressly authorizes investment companies to contribute a portion of their capital to companies organized by themselves to underwrite the securities of, and to furnish capital to, industry.

TITLE I. INVESTMENT TRUSTS AND INVESTMENT COMPANIES

A detailed discussion of the background of this bill and the evils it is intended to remedy appears in the report to the Senate Banking and Currency Committee to the Senate, Report No. 1775, and the reports of the Securities and Exchange Commission to the Congress made pursuant to section 30 of the Public Utility Holding Company Act

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of 1935. Only a brief recital of the background of the bill and the more important abuses in investment companies will be described in this report.

Investment trusts and investment companies are in essence institutions for the investment of the savings of small investors in securities, particularly the common stocks of industrial and other companies. Four types of investment enterprises exist:

(1) Management investment companies in which management has complete discretion as to the investments to be made. These companies are subdivided into open-end

companies—those in which the security holders can at their option compel the company to redeem or repurchase their securities at the actual asset value of such securities; and closed-end companies—those which do not accord this privilege to stockholders;

(2) Unit investment trusts in which no management exists and the investor is sold an undivided interest in a specific package or unit of securities, the composition of which is relatively unchangeable;

(3) Periodic payment plans which in essence are merely devices to sell the securities of management investment companies or unit investment trusts on the installment plan to small investors; and

(4) Face-amount-certificate companies which sell to the public face-amount certificates whereby in consideration of the payment of certain specified installments the corporation agrees to pay to the purchaser at maturity a definite sum, the face amount of the certificate; or to pay, prior to maturity, a specified surrender value of the certificate. Robert E. Healy, Commissioner of the Securities and Exchange Commission, who had general supervision of the investment-trust study, generally described these organizations as follows:¹

Let me try my hand at a general description of investment trusts and investment companies. Essentially these organizations are large liquid pools of the public's savings entrusted to managements to be invested. The sales and promotional literature of investment trusts and investment companies has created the impression that they are not unlike savings banks and insurance companies, except that they are not limited to so-called legal investments. The sales emphasis by promoters of investment companies has been upon the necessity for providing security for old age and for emergencies, and upon the claim that by expert management and diversification of risk, this security can be furnished by these organizations.

For example, Charles A. Kettering, vice president and research director of General Motors Corporation (and I pause to say, one of our most useful and finest citizens), testified at the public examination that in 1930 he purchased 40,000 shares of an investment company for \$260,000 in the belief that it gave him a participation in a wide range of securities and was "akin or about the same participation you would get in, say, one of these single payment life-insurance companies." He said that he did not know that investment companies were not subject to supervision as were life-insurance companies or banks. Ultimately Mr. Kettering realized only \$20,000 on his investment—that is, he lost approximately a quarter of a million dollars. And, incidentally, I may add that he served as a director of that company; said he had been unable to attend meetings, and said he did not understand investments; adding, what interested me greatly, that he saw life through the laboratory window.

Commenting on the losses of the American public in these institutions, Mr. Healy stated:

The interest of the public in investment trusts and investment companies has been and still is very large. In the last 15 years approximately 1,300 such companies have been created. Speaking generally these organizations have made _____

comparatively little original contribution of capital to industry, the investments for the most part being in securities already issued and outstanding. The reason for that I think will appear before the hearings are over. It is due, in part, to the necessity of some companies keeping themselves in a strictly liquid position. The American public has contributed over \$7,000,000,000 to these organizations. That is on the basis of investment. You can compare that with \$14,000,000,000 roughly estimated as the investment in the electric light industry. The value of their assets at present is approximately \$4,000,000,000. At present only some 650 or approximately one-half of investment companies formed in this country, are still in existence. The other companies have disappeared through bankruptcy, receivership, dissolution, mergers, and consolidations. With respect to 22 of the bankrupt companies upon which the Commission has reasonably accurate figures, the security holders sustained a capital loss to December 31, 1935, of approximately \$510,000,000 out of a total net capital contribution of almost \$560,000,000, or a loss of about 90 percent. Altogether investors have

¹ Hearings before a subcommittee of the Committee on Banking and Currency, U.S. Senate (76th Cong., 3d sess.), on S. 3580, a bill to provide for the registration and regulation of investment companies and investment advisers, pp. 33 et seq.

sustained a capital shrinkage of approximately \$3,000,000,000 in all types of investment trusts and investment companies.

Discussing the national public interest in investment trusts and investment companies, Mr. Healy stated:

Many individual investment companies have total assets equal to those of the larger savings banks. Their securities are owned by approximately 2,000,000 investors throughout this country, with the majority of the individual investments in such securities having a value under \$500. The number of security holders of investment trusts and companies probably exceeds that of all other industries except utility holding company systems. It is estimated that one out of every 10 holders of securities of all types in this country is a holder of investment trust and investment company shares or certificates.

In addition, investment companies at present control or are in a position to control or importantly influence various industrial, banking, utility, and other enterprises having total assets which, as of the end of 1935, amounted to some \$30,000,000,000. Furthermore, these investment trusts and investment companies, because of their very substantial trading in securities on stock exchanges, are a most substantial factor in our securities markets.

Because of the large public interest in these organizations, and because these investment trusts and investment companies represent unsupervised pools of savings, these institutions have been a matter of concern to representatives of the investment company industry, stock exchanges, financial writers, and governmental bodies from the early period of their existence in this country. The potential dangers of these organizations have been indicated, and with the passing years criticism has increased.

This tremendous loss must be principally attributed, of course, to the sharp decline in security values since 1929. However, in a substantial number of instances, losses suffered by investors were caused in good part by selfish, and in some cases unscrupulous, mismanagement of investment trusts and investment companies. The record of the study and the reports to the Congress of the Securities and Exchange Commission and the testimony taken before the Senate Committee on Banking and Currency contains many examples of abuses in the organization and operation of investment trusts and investment companies. These abuses have been persistent and have occurred and recurred constantly during the last 10 years.²

The investors in investment trusts and investment companies are subject to substantial losses at the hands of unscrupulous persons is obvious from the very nature of the assets of such companies. Their assets consist almost invariably of cash and marketable securities. They are liquid, mobile, and easily negotiable. These assets can be easily misappropriated, "looted," or otherwise misused for the selfish _____ purposes of those in control of these enterprises. In the absence of regulating legislation, individuals who lack integrity will continue to be attracted by the opportunity available for personal profit in the control of the liquid assets of investment trusts and investment companies.

Little capital is needed to form and market the securities of investment trusts and investment companies, and there is nothing to prevent irresponsible individuals and even individuals actually convicted of, or enjoined by the courts for, financial frauds from forming and controlling investment companies by a variety of devices such as special voting stocks, long-term management, and underwriting contracts, voting trusts, and the pyramiding of investment companies which do not require them to make any pecuniary investment in the enterprise. In addition, brokers, security dealers, and investment bankers are in a position to use controlled investment companies solely as financial adjuncts to enhance their own banking and brokerage businesses.

² See Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies, pt. III, H. Doc. 279 (76th Cong.); also testimony of David Schenker, counsel to Investment Trust Study, hearings before Senate Banking and Currency Committee on S. 3580, pp. 970, et seq.

The distribution and repurchase of the securities issued by investment companies have on occasion resulted in discrimination in favor of the management or other "insiders" who have been able to acquire the securities and to have the companies repurchase them on a basis more favorable than that accorded to public stockholders. In the open-end companies the method of pricing their securities which they are continuously selling and redeeming may tend at times to substantial dilution of the investors' equity in the companies and in some instances have been used by persons closely connected with the companies to realize riskless trading profits.

Furthermore, the capital structures of investment companies have often been extremely complex, and the rights, preferences, and dividend or interest claims of the senior securities of such companies sold to the public; that is, their bonds and preferred stocks have in many cases been inadequately safeguarded. In the case of unit investment trusts and open-end management investment companies, investors have been sold securities in one of such enterprises and then repeatedly "switched" into other investment trusts and companies organized by the promoters of the original company or trust solely for the purpose of exacting additional selling charges and profits from the investor. Some of the most unfair selling practices have occurred in the case of the companies which sell investment-company securities on the installment plans—so-called periodic payment plans. These companies sell to investors in the lowest income brackets who are not in a financial position to invest their surplus funds in common stocks and who almost invariably have great difficulty in making the required installment payments. They have sold securities carrying selling charges which sometimes approached 25 percent of the price paid by the investor. With the knowledge that the class of individuals who invest in these installment plans, because of their financial status, will rarely be able to complete even the first year's payments, the entire first year's payments have been used to pay selling charges. As a result, thousands of small investors have lost their entire savings in these plans.

Similar practices exist in the case of companies selling face-amount certificates on the installment plan. The lapse experience of investors in these certificates has been high and in some cases the assets

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of the companies have been carried at highly fictitious values and in some cases inadequate reserves have been maintained to meet the obligation of the companies of their outstanding certificates. No uniform actuarial reserve system is required by law for these companies.

With respect to the management of the assets of investment companies many abuses have existed. First the promoters and managers of investment companies determine the direction and scope of the business activities of the company and have the power to change, without the prior approval of the security holders, investment policies originally undertaken. The security holder has, therefore, no assurance of the stability of any announced investment policies of his company and no voice in the determination of any desire of the management to change such policies. Similarly, after investors have invested in investment companies on their faith in the reputation and standing of the existing managements, control of the public's funds has frequently been transferred without the prior knowledge or consent of stockholders to other persons who have looted the assets of such companies or to other investment companies which have subjected the stockholders to grossly unfair plans of merger, consolidation, or other corporate readjustments.

Second, unscrupulous individuals in control of investment companies have not hesitated to engage in self-dealing; that is, transactions between officers, directors, and similar persons and the investment companies with which they are associated. These individuals

have sold worthless securities at extravagant prices to their controlled companies, have purchased securities and other property from such companies at unfairly low prices, and have borrowed extensively and without repayment from such companies. The industry recognized that even for the most conscientious managements, transactions between these affiliated persons and the investment companies present many difficulties. Many investment companies have voluntarily barred this type of transaction.

Finally the investor has been unable to obtain adequate financial information as to the operations of investment companies. The accounting practices and financial reports to stockholders of management investment companies frequently are deficient and inadequate in many respects. Often they are misleading. In many cases dividends have been paid without notifying stockholders that such dividends did not constitute earnings but were a return of the capital invested by the stockholder.

NECESSITY FOR LEGISLATION

It is not to be implied or inferred that most investment trusts and investment companies at present operating in this country were guilty of unfair practice or were mismanaged. In the last decade some progress has been made by the members of the industry voluntarily to eliminate some of the major malpractices, and to improve generally standards of practice in the light of experience. However, it is clear that malpractices cannot be eliminated without the enactment of a Federal law to regulate these institutions. This conclusion was conceded by virtually every witness who appeared before the subcommittee and is the virtually unanimous opinion of the entire industry itself.

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The Securities Act of 1933 and the Securities Exchange Act of 1934 have not acted as deterrents to the continuous occurrence of abuses in the organization and operation of investment companies. Generally these acts provide only for publicity. The record is clear that publicity alone is insufficient to eliminate malpractices in investment companies. Further, the great majority of investment companies have never come within the purview of these acts.

In the opinion of the committee, the Securities and Exchange Commission, and the industry itself, this legislation is needed to protect small investors from breaches of trust upon the part of unscrupulous managements and to provide such investors with a regulated institution for the investment of their savings. This legislation will also prevent those abuses which have damaged the reputation of the industry as a whole.

Representatives of the Securities and Exchange Commission in connection with the bill and members of the industry who appeared at the hearings called the attention of the subcommittee to the serious tax problem affecting investment companies. This problem has already been recognized by the Congress in the case of certain open-end management investment companies which receive special tax treatment under existing Federal revenue acts. The record before the committee indicates that the tax problem is very pressing with respect to closed-end management investment companies of the type classified in this bill as "diversified." If the bill is passed the committee believes that the tax problem of these companies should receive prompt consideration by the Congress.

ANALYSIS, BY SECTIONS

- Section 1: Findings and declaration of policy.
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- Section 18: Capital structure.
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- Section 20: Proxies, voting trusts, circular ownership.
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- Section 23: Distribution and repurchase of securities: Closed-end companies.
- Section 24: Registration of securities under Securities Act of 1933.
- Section 25: Plans of reorganization.
- Section 26: Unit investment trusts.
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- Section 28: Face-amount-certificate companies.
- Section 29: Bankruptcy of face-amount-certificate companies.
- Section 30: Periodic and other reports; reports of affiliated persons.
- Section 31: Accounts and records.
- Section 32: Accountants and auditors.
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- Section 37: Larceny and embezzlement.
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- Section 47: Validity of contracts.
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- Section 49: Penalties.

Section 50: Effect on existing law.
Section 51: Separability of provisions.
Section 52: Short title.
Section 53: Effective date.

Section 1. Findings and general policy

This section sets forth the findings of the Congress with respect to investment companies and the declaration of policy of the bill.

Section 2. General definitions

This section sets forth the general definitions of terms used in the bill.

Section 3. Definition of investment company

Subsection (a) specifies that the following companies are within the purview of the bill: Companies which are engaged primarily in the business of investing, reinvesting, and trading in securities; and issuers which invest in or hold securities (other than securities of noninvestment company subsidiaries) having a value exceeding 40 percent of the value of their total assets. A third group of companies covered by the bill are companies which engage in the business of issuing so-called face-amount installment certificates.

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Subsection (b) excludes from the bill companies primarily engaged, directly or through subsidiaries, in the operation of a business other than that of an investment company.

Subsection (c) specifically excludes brokers, underwriters, banks, insurance companies, common or commingled trust funds administered by a bank, bank-holding company affiliates subject to the supervision of the Board of Governors of the Federal Reserve System, companies subject to the Interstate Commerce Act, and those of their wholly owned subsidiaries substantially all of whose assets consist of securities of companies which themselves are subject to the Interstate Commerce Act, small-loan companies, factoring companies, companies dealing in mortgages or discount papers, holding companies subject to the Public Utility Holding Company Act of 1935, and certain other special types of companies.

Section 4. Classification of investment companies

Section 4 classifies investment companies into three categories: Management companies, unit-investment trusts, and face-amount-certificate companies.

Section 5. Subclassification of management companies

Subsection (a) divides management companies into two types: Open-end companies—companies in which the stockholder or certificate holder has a right to compel the company to redeem his shares at their asset value; and closed-end companies—companies in which the shareholders do not have such a right.

Subsection (b) further subclassifies management companies, both of the open-end and closed-end types, upon the basis of the extent of the diversification of their investments,

into diversified companies and nondiversified companies. Diversified companies must have at least 75 percent of their assets in diversified securities, and with respect to this 75 percent of the assets, no more than 5 percent can be invested in more than 10 percent of the outstanding voting securities of any one company. Nondiversified companies are not required so to diversify their investments.

Subsection (c) is a technical paragraph and provides that if the company has invested only 5 percent of its assets in one company and if the market value of that investment goes up so that its value is more than 5 percent of the investment company's assets, it does not lose its status of a diversified company.

Section 6. Exemptions

Subsection (a) (a) exempts from the provision of this bill investment companies organized or created under the laws of Alaska, Hawaii, Puerto Rico, the Philippine Islands, the Canal Zone, and the Virgin Islands, provided they do not sell any securities to residents of any State other than the State in which they were organized.

Paragraph (2) exempts companies which, on the effective date of this act, were in receivership or bankruptcy, and such exemption shall continue as long as the company's business is under court jurisdiction.

Paragraph (3) exempts companies which have gone through reorganization and are temporarily investing their cash in securities.

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Paragraph (4) exempts face-amount-certificate companies which were organized under the insurance laws of a particular State and are subject to the supervision of an insurance commissioner, and all of the stock of which has been sold in that State. Subsection (b) empowers the Commission to exempt by order employees' investment companies.

Subsection (c) empowers the Commission to exempt other companies if such exemption is consistent with the protection of investors.

Subsection (d) authorizes the exemption of certain small closed-end investment companies doing an intrastate business.

Subsection (e) provides that a company is not required to be registered in order to subject it to specific provisions of the bill; and conversely, the Commission is empowered to relieve the company from all provisions, including registration, and just subject it to those which it may fine are particularly applicable to that company.

Section 7. Transactions by unregistered investment companies

Subsection (a) provides that an investment company, unless it is exempt, or unless it is registered as provided in the bill, is forbidden to conduct its activities through use of the mails or instrumentalities of interstate commerce.

Subsection (b) makes the same provision with respect to fixed and semifixed investment companies.

Subsection (c) provides that no promoter of a proposed investment trust shall use the mails or any means of interstate commerce to sell preorganization certificates.

Subsection (d) provides that foreign investment companies may not register as investment companies or publicly offer securities of which they are the issuer in the United States unless the Commission finds that these foreign investment companies can be effectively subjected to the same type of regulation as domestic investment companies.

Section 3. Registration of investment companies

Subsection (a) provides that the registration of any investment company may become effective upon the filing with the Commission of a notification of registration.

Subsection (b) provides that the formal registration statement may be filed by a company after effective registration at some time to be fixed by the Commission. In the main, the Commission may require the information required to register securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. In addition, the registration statement must state the policy of the company as to items specifically enumerated in the bill and supply information with respect to the business affiliation and experience of the officers and directors of the company.

Subsection (c) makes provision for the simplification of the registration procedure by permitting the filing of copies of registration statements already filed under the acts now administered by the Commission.

Subsection (d) empowers the Commission to exempt unit investment trusts from supplying information in its registration statement

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which may duplicate information supplied by a registered investment company all of whose securities are substantially owned by the unit investment trusts.

Subsection (e) sets forth the mechanics for correcting and for revealing omission of material facts.

Subsection (f) empowers the Commission to cancel the registration statement of an investment company if the Commission find [sic] that a company has ceased to be an investment company.

Section 9. Ineligibility of certain affiliated persons and underwriters

Subsection (a) provides that any person who within 10 years has been convicted of a crime, or is enjoined by a court in connection with a security or financial fraud, is prohibited by the bill from acting as an officer, director, member of an advisory board, investment advisor, or depositor of any investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered faceamount company.

Subsection (b) authorizes the Commission to exempt persons from the prohibition set forth under subsection (a) where it is shown that the penalty as applied to any such person would be unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors that such exception be granted.

Section 10. Affiliations of directors

Subsection (a) provides that at least 40 percent of the board of directors of an investment company shall be "independent"; that is, no more than 60 percent may consist of investment advisers to the company or affiliated persons of such an adviser or officers or employees of the company.

Subsection (b) provides that a majority of the board of directors of an investment company must be composed of persons who are not regular brokers for the company or

principal underwriters of its securities, or investment bankers, or in each case persons affiliated with them.

Subsection (c) provides that after the effective date of this title, the majority of the board of directors of an investment company may not consist of persons who are officers or directors of any one bank, except that any investment company which, on March 15, 1940, shall have had a majority of its directors consisting of such persons may continue to do so.

Subsection (d) exempts from the provisions of subsections (a) and (b) of this section (10) directors of certain types of investment companies which are closely affiliated with investment advisers and which are designated primarily to make available the medium of diversification to the smaller customers of these advisers. This exception is carefully safeguarded by specific condition.

Subsection (e) provides that any change in the board of directors resulting from the death, resignation, or disqualification of a director resulting in a violation of subsections (a), (b), or (c) must be filled within 30 days, if only the action of the board of directors is required, or within 60 days if a stockholders' vote is required to fill the vacancy,

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as the Commission may designate by rules and regulations or order.

Subsection (f) prohibits investment companies from purchasing securities underwritten by persons affiliated with the investment company, unless the investment company itself is a principal underwriter of such securities, until after the termination of the underwriting syndicate.

Subsection (g) subjects the members of an advisory board to the restriction of subsections (a), (b) and (c), (e) and (f).

Subsection (h) makes the provisions of subsection (a) as modified by subsection (e) applicable to the boards of directors of the depositor of an unincorporated management company; makes the provisions of subsections (b) and (c) as modified by (e) applicable to the board of directors of the depositor and of every investment adviser of such company; and makes the provisions of subsection (f) applicable to acquisitions of securities when the depositor or investment adviser, or persons affiliated with them, is the underwriter of such securities.

Section 11. Offers of exchange

Subsection (a) provides that exchange offers of open-end companies made on any other basis than respective asset values of the securities involved must be submitted for the approval of the Commission.

Subsection (b) exempts from the provision of subsection (a) those exchange offers which are made in connection with reorganizations.

Subsection (c) subjects the exchange offers of the securities of open-end companies for the securities of unit-investment trusts or face-amount-certificate companies, and the exchange offers of securities of unit-investment trusts or face-amount-certificate companies for the securities of any other investment company, to the restriction set forth in subsection (a), irrespective of the basis of exchange.

Section 12. Functions and activities of investment companies

Subsection (a) makes it unlawful for investment companies to trade on margin, participate in joint-trading accounts, or effect short sales in portfolio securities in contravention of rules and regulations which may be prescribed.

Subsection (b) provides that an open-end company cannot be its own distributor except in accordance with the Commission's rules and regulations.

Subsection (c) permits a diversified company to engage in underwritings provided these commitments do not exceed 25 percent of its total assets.

Paragraph (1) of subsection (d) provides that an investment company or group of controlled companies may not purchase securities issued by another investment company if as a result of such acquisition such group will have more than 3 percent of the outstanding voting securities of such other investment company, or 5 percent of a specialized investment company. Investment companies, however, may increase their holdings in other investment companies of which they already hold 25 percent of the voting stock, since such holdings constitute presumptive control.

Paragraph (2) of subsection (d) limits the acquisition by investment companies of an insurance company's stock to 10 percent of such

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company's outstanding stock. However, investment companies may increase their holdings in insurance companies of which they already hold 25 percent of the voting stock.

Paragraph (3) of this subsection prohibits investment companies from acquiring securities of persons engaged in the brokerage business or in the business or underwriting and dealing in securities unless the investment company will, after such acquisition, own all outstanding securities of such person and the principal business of such company is that of underwriting securities.

Subsection (e) permits investment companies, either alone or jointly with other investment companies, to purchase stock of a company engaged primarily in the business of underwriting and distributing securities and to acquire stock of a company formed to engage in the business of furnishing new capital to industry, financial promotional enterprises, and similar activities.

Subsection (f) provides that a face-amount-certificate company can acquire the securities of not more than two other face-amount-certificate companies only upon certain prescribed conditions.

Subsection (g) permits an investment company to acquire more than 10 percent of the outstanding voting securities of an insurance company where it is found that such acquisition is in the public interest because the financial condition of such insurance company will be improved as a result of such acquisition or any plan contemplated as a result thereof. This subsection also permits investment companies to participate in the organization of new insurance companies and to purchase the stock of newly created insurance companies from other investment companies. The powers of any insurance commissioner or similar official or agency of the United States or any State are in no way to be affected by any of the provisions of this section.

Section 13. Changes in investment policy

Subsection (a) provides that no shift in an investment company's fundamental policies as stated in its registration statement may be made without the approval of a majority of the company's outstanding voting securities.

Subsection (b) defines what shall constitute a vote of the majority of the outstanding shares in the case of a common-law trust.

Section 14. Size of investment companies

Subsection (a) provides that no investment company organized after the effective date of this bill may make a public offering of its securities unless it has or is assured of having at least \$100,000 through private subscriptions.

Subsection (b) authorizes the Commission to study and report from time to time the effect of size of investment companies, both on the national economy and on the trusts themselves.

Section 15. Investment advisory and underwriting contracts

Subsection (a) provides that after 1 year from the effective date of this title all investment advisory or management contracts must be in writing, must prescribe in detail the compensation to be paid,

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and must be nonassignable and terminable upon 60 days' notice. Such contract have to be approved by a majority of the voting stock, may be for an initial period of 2 years, and renewable annually thereafter by the board of directors or stockholders.

Subsection (b) makes the provisions of subsection (a) except stockholders' approval applicable to contracts for the distribution of open-end company securities.

Subsection (c) provides that investment advisory or management contracts and underwriting contracts for the distribution of the securities of open-end investment companies can be entered into or renewed only upon the approval of a majority of the directors independent of those persons who may either be parties to the contract or persons who may be affiliated with such parties.

Subsection (d) provides that contracts in existence as at March 15, 1940, are permitted to continue for a period not exceeding 5 years, unless such contracts have been renewed in accordance with the provision of subsection (a) or (b) prior to March 15, 1945. Subsection (e) defines what shall constitute the vote of a majority of the outstanding voting securities in the case of a common-law trust.

Subsection (f) provides that none of the restrictions set forth in the foregoing subsections of this section are to apply to the members of an advisory board.

Section 16. Changes in board of directors; provisions relative to strict trusts

Subsection (a) provides that in the future no person shall serve as a director of an investment company unless elected by the holders of its outstanding voting securities, except that, in effect, vacancies not exceeding one-third of the board occurring between meetings of stockholders may be filled in any otherwise legal manner.

Subsection (b) provides a procedure for the removal of trustees of existing strict trusts by certificate holders where no provision is made for their election.

Section 17. Transactions of certain affiliated persons and underwriters

Subsection (a) of this section makes it unlawful for persons who are officers, directors, promoters, investment advisers, etc., or persons affiliated with such persons acting as

principal, knowingly to sell to or purchase from their investment company any securities or property or borrow from such investment company.

Subsection (b) provides that the Commission may grant exemptions from subsection (a) if the transaction is fair and is consistent with the investment policies of the company and with the purposes of this bill.

Subsection (c) provides that notwithstanding subsection (a) a person may sell to or purchase from any investment company merchandise, or may enter into lessor-lessee relationship with an investment company.

Subsection (d) prohibits joint participation and transactions between investment companies and their officers, directors, investment advisers, principal underwriters, etc., in contravention of rules and regulations of the Commission promulgated for the purpose of limiting or preventing participation by the investment company on a basis dif-

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ferent from or less advantageous than that of such other participants.

Subsection (e) provides that brokerage commissions from investment companies obtained by affiliated persons are to be limited to standard rates, with provision for special exemptions.

Subsection (f) provides that the portfolio securities of investment companies must be placed in the custody either of banks or with certain types of stock-exchange firms or with the investment company subject to supervision by the Commission as to methods of safekeeping, etc.

Subsection (h) provides that directors and officers, and subsection (i) provides that principal underwriters and investment advisers of registered investment companies are not to be permitted to exculpate themselves from liability for willful misfeasance, bad faith, gross negligence, or reckless disregard of their duties.

Section 18. Capital structure

Subsection (a) makes it unlawful for closed-end companies to issue securities representing indebtedness or preferred stocks unless such securities have an asset coverage of at least 300 percent and 200 percent, respectively. Dividends may not be paid on the common stock unless the securities representing indebtedness have an asset coverage of 300 percent and the preferred stock an asset coverage of 200 percent. Dividends cannot be paid on the preferred stock unless such indebtedness has an asset coverage of 200 percent. Unless these coverages are maintained repurchases of securities junior to senior securities are forbidden. Voting rights are also provided for preferred stocks and in certain contingencies for senior securities representing indebtedness other than loans.

Temporary borrowings up to 5 percent are exempt from the foregoing provisions. Subsection (b) provides for the time at which asset coverages must be calculated for the purposes of the preceding section.

Subsection (c) provides that investment companies may not issue more than three classes of securities—one class of security representing indebtedness (including loans not publicly distributed), one class of preferred stock, and one class of common stock. Subsection (d) provides that hereafter investment companies may not issue warrants to purchase their securities except warrants or rights offered to their security holders which

expire in 120 days. In the case of reorganization, however, warrants may be issued for existing warrants.

Subsection (e) exempts from other provisions of the section senior securities issued by investment companies to refund senior securities and senior securities issued in connection with reorganization provided, speaking generally, that as a result of the reorganization the ratio of senior securities to various stocks is not increased over such ratio as it existed prior to the reorganization.

Subsection (f) prohibits open-end companies from issuing senior securities except that such companies are permitted to borrow from banks provided that an asset coverage of 300 percent is maintained at all times for such borrowings.

Subsections (g) and (h) define "senior securities" and "asset coverage," respectively.

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Subsection (i) provides that hereafter every share of stock issued by a registered management investment company (except a common-law trust of the character described in sec. 16) shall be a voting stock and have equal voting rights with every other outstanding stock. The right to elect a majority of the directors must be accorded to preferred-stock holders in the event of default in 2 years' dividends on their stock. Subsection (j) provides that in the future face-amount certificate companies cannot issue senior capital securities or, if such company has such securities outstanding, to make any distribution or pay any dividend in contravention of rules and regulations of the Commission prescribed to insure the financial integrity of the company and to prevent the impairment of the company's ability to meet its obligations on its face-amount certificates. If a face-amount certificate company does not maintain the minimum certificate reserves on all its face-amount certificates issued prior to the effective date of the bill, then the company cannot make any distribution or pay any dividend on any senior capital security which exceeds a prescribed percentage of its earnings or which the Commission determines might impair the financial integrity of the company or its ability to meet its liabilities on its outstanding face-amount certificates. Finally, face-amount certificate companies may issue their securities only for cash or securities including their own outstanding securities.

Section 19. Dividends

This section provides, in respect of dividends on existing securities issued by investment companies as well as securities issued by such companies in the future, that the investment companies must disclose by written statement accompanying such dividends the source of such payment when made other than from current or accumulated net income as defined.

Section 20. Proxies; voting trusts; circular ownership

Subsection (a) provides that solicitation of proxies, consents, and authorizations relating to securities of investment companies registered under this bill are to be subject to the regulations to which solicitations relating to securities listed on national securities exchanges are already subject by reason of the Commission's regulations adopted under section 14 (a) of the Securities Exchange Act of 1934. To assure uniformity of interpretation and administration as between that act and the present bill, section 20 (a) of the bill has been so drafted as to follow verbatim section 14 (a) of the Securities Exchange Act, with only slight modifications of language as are necessary because of the special classes of companies to which section 20 (a) of this bill applies.

Subsection (b) provides that hereafter no public offering by the use of the mails or means or instrumentalities of interstate commerce shall be made of voting-trust certificates of investment companies. However, existing voting trusts for investment companies may continue until their expiration.

Subsection (c) provides that no investment company shall purchase any voting security if to the knowledge of such company cross or circular ownership of securities exists or will exist between the invest-

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ment company and the company whose securities it purchases. Cross ownership is defined to exist between two companies when each company owns more than 3 percent of the voting securities of the other company. Circular ownership is defined to exist among companies included in a group of three or more companies if two or more of such companies own 3 percent or more of the voting securities of each other.

Subsection (d) provides that cross or circular ownership between investment or other companies now in evidence must be eliminated within 5 years. If cross or circular ownership comes into effect between an investment company and other companies after the effective date of this bill upon the purchase by a registered investment company, such company is required to eliminate such cross or circular ownership within 1 year after knowledge of its existence.

Section 21. Loans

This section makes it unlawful for investment companies to lend money or property to any person if (1) such loan is not authorized by the investment policies of the company as recited in its registration statement and reports filed with the Commission, or (2) the loan is made to a person which controls or is under common control with the investment company. Exception is made for the renewal of loans outstanding prior to March 15, 1940, and for loans by a registered company to a person owning all of its outstanding securities.

Section 22. Distribution, redemption, and repurchase of redeemable securities

Subsections (a) and (b) empower an association of securities dealers registered under section 15A of the Securities Exchange Act of 1934, subject to the provisions of that section, to make rules to protect investors so far as is reasonably practicable, against any dilution of their equity due to the methods or pricing, distribution, and redemption of redeemable securities issued by investment companies and to prevent grossly excessive sales loads upon such securities.

Subsection (c) empowers the Commission, after 1 year, to make rules and regulations to deal with the subjects mentioned in subsections (a) and (b). In other words, the industry is given a year to solve these problems for itself.

Subsection (d) prohibits investment companies from selling their redeemable securities to any person other than a dealer or principal underwriter at a price less than that at which the security is sold to the public.

Subsection (e) prohibits the suspension of redemption of redeemable securities issued by investment companies for a period more than 7 days except during certain specified emergency periods or other periods fixed by the Commission.

Subsection (f) provides that the negotiability or transferability of redeemable securities of open-end companies may not be restricted in contravention of rules and regulations which the Commission may prescribe.

Subsection (g) provides that open-end investment companies may issue their securities only for cash or securities. However, such

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securities may be issued as stock dividends or for property pursuant to a plan of reorganization of such company.

Section 23. Distribution and repurchase of securities: Closed-end companies

Subsection (a) provides that no closed-end investment company may issue its securities except for cash or securities. However, such company may issue securities as stock dividends or for property in connection with a plan of reorganization of such company.

Subsection (b) provides that closed-end companies may not issue their common stock below asset value except in connection with an offering to their own security holders, conversion of a convertible security exercise of any warrant outstanding at the date of enactment of the bill, or with the consent of a majority of their common-stock holders.

Subsection (c) provides that no closed-end company may repurchase any of its outstanding securities except on a securities exchange or open market upon prescribed notice to its stockholders or pursuant to tenders or under other circumstances to be prescribed to insure fair treatment to all security holders.

Section 24. Registration of securities under Securities Act of 1933

In order to eliminate duplication in the material filed under the Securities Act and this bill, subsection (a) of this section provides that investment companies may register under the Securities Act of 1933 by filing copies of their registration statements under this title and such other information as the Commission may prescribe.

Subsection (b) provides that sales literature intended for distribution to prospective purchasers of the securities of open-end companies, unit investment trust, and faceamount certificate companies must be filed with the Commission within 10 days after the distribution of such literature by the use of the mails or means or instrumentalities of interstate commerce.

Subsection (c) empowers the Commission to prescribe the form in which information shall be presented or summarized in the prospectuses used by face-amount certificate companies and periodic payment plans.

Subsection (d) provides that the provisions of section 3 (a) (8) of the Securities Act shall be inapplicable to securities issued by investment companies. The provisions of section 3 (a) (11) of the same act are made inapplicable to securities of registered investment companies.

Section 25. Plans of reorganization

Subsection (a) requires that information relating to plans of reorganization of investment companies be filed with the Commission.

Subsection (b) provides that the Commission, at the request of 25 percent of any class of the security holders to be affected by such reorganization, or at the request of a company

which is a party to such a plan, may render an advisory report as to the fairness of the plan. The company is required to send a copy of any such report to its security holders.

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Subsection (c) authorizes the Commission to institute injunction proceedings in a Federal court to restrain the consummation of any grossly unfair plan of reorganization or any plan which constitutes gross misconduct or gross abuse of trust.

Subsection (d) makes it clear that the functions and duties of the Securities and Exchange Commission under the Bankruptcy Act remain unchanged.

Section 26. Unit investment trusts

Under subsection (a), the trust indentures of unit investment trusts must designate as trustee or custodian a bank of a specified minimum size; must require that all property and funds of the trust will be held by the trustee; and must provide, among other things, that the trustee (which may not resign unless a successor trustee has been designated or the trust liquidated) be entitled to reimburse itself out of the trust property for its expenses actually incurred and fees actually earned. Except under special circumstances, the depositor or underwriter must be prohibited from deriving any fees from the trust other than the original sales load for distributing the shares. Provision must also be made to advise shareholders of portfolio changes.

In view of the fact that amendment of existing trust indentures to comply with subsection (a) may in certain cases involve appreciable effort and expense, subsection (b) permits the same result to be accomplished by a written contract between the depositor and trustee.

Subsection (c) authorizes the institution of proceedings in court by the Commission to liquidate so-called "orphan" trusts.

Section 27. Periodic payment plans

Subsection (a) contains provisions which limit the sales load on period-payment-plan certificates to 9 percent; permit half of the sales load to be taken out during the first year of the plan but require the balance to be spread equally over the subsequent year; require the initial payment under any plan to be at least \$20, and each subsequent payment at least \$10; and to prevent evasion of the restrictions on sales load by the imposition of so-called management fees; authorize the Commission to prescribe maximum fees. Under subsection (b), the Commission may modify the provisions of subsection (a) relative to sales load in order to meet the problems of smaller companies.

Subsection (c) requires that periodic-payment-plan certificates be redeemable securities and that the proceeds of payment thereon be deposited with a trustee or custodian having the qualifications required for unit-investment trusts, under an indenture or agreement meeting certain of the conditions required of the trust indentures of unit-investment trusts.

Section 28. Face-amount-certificate companies

Paragraph (1) of subsection (a) provides that companies which sell face-amount certificates are generally subject to the provisions of the bill but must comply with certain

provisions which are specifically applicable to that type of company. The bill contains provisions

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with respect to minimum capitalization of face-amount-certificate companies.

Paragraph (2) of subsection (a) provides that all companies which in the future sell these certificates must at all times maintain reserves, which, accumulated at a rate not to exceed 3½ percent compounded annually must provide an amount sufficient to meet at all times all the liabilities and obligations of the company to all its certificate holders.

Subsection (b) provides that companies must have cash or qualified investments (investments which are qualified under the Code for the District of Columbia for life insurance companies) of a value not less than the aggregate of their capital and reserve requirements.

Subsection (c) requires face-amount-certificate companies to deposit with certain qualified banks all or any part of the investments maintained by such company as certificate reserve requirements, except that the company may be credited with deposits made pursuant to law or regulation with State authorities in respect to liabilities of the certificates sold to the residents of such States.

Subsection (d) requires that the loading charge (the maximum amount of which charge is fixed by the bill) for the distribution of the certificate be spread over the life of the certificate. In essence, no more than 50 percent of the load may be taken out the first year, no more than 7 percent in each of the following 4 years, and not more than 4 percent in each of the remaining years. The surrender value of the certificate for the first year must be equal to at least 50 percent of the gross annual payment made on the certificate, less a prescribed surrender charge.

Subsection (e) provides that a certificate may not contain a provision making the holder liable for any unpaid balance on the certificate.

Subsection (f) requires that the certificate must provide for the issuance of a so-called paid-up certificate to the certificate holder upon the happening of certain contingencies. Subsection (g) provides that the foregoing provisions are not applicable to certificates issued to holders of certificates issued before the effective date of the act.

Subsection (h) provides that if a face-amount company does not maintain the minimum certificate reserve on all its outstanding face-amount certificates issued prior to the effective date of the bill, then the company cannot make any distribution or pay any dividend on any senior capital security which exceeds a prescribed percentage of its earnings or which the Commission determines might impair the financial integrity of the company or its ability to meet its liabilities on the outstanding certificates.

Section 29. Bankruptcy of face-amount-certificate companies

Subsection (a), while preserving the rights, even in the event of bankruptcy, of residents in those States which require specific deposits with their State officials, promotes more equal treatment of all certificate holders by providing that residents of other States must receive an amount equal to that received by the residents of States with deposits, before the latter can share in the general assets of the bankrupt company.

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Subsection (b) provides that the trustee in bankruptcy of a face-amount-certificate company shall be appointed by the court instead of being elected by certificate holders and

other creditors scattered throughout the Nation. The Securities and Exchange Commission is entitled to be heard by the court before the appointment is made.

Section 30. Periodic and other reports; reports of affiliated persons

Subsection (a) requires investment companies to file with the Commission annual reports, including financial statements, similar to the annual reports now filed with the Commission under the Securities Exchange Act of 1934 by companies having securities listed on national securities exchanges.

Subsection (b) authorizes the Commission to require less comprehensive reports on a semiannual or quarterly basis. It also provides that investment companies must file with the Commission copies of reports sent to their security holders.

Subsection (c) provides that copies of reports filed hereunder may be filed in substitution for reports which the company would otherwise be required to file pursuant to the Securities Exchange Act of 1934.

Subsection (d) authorizes the Commission to require investment companies to transmit semiannually to their stockholders reports containing certain specified financial and other information. The reports to stockholders may not be misleading in any material respect in the light of the reports filed with the Commission.

Under subsection (e), annual reports to the Commission and to stockholders may be required to be certified by independent public accountants, whose certificate must be based on a reasonably comprehensive audit.

Under subsection (f), the provisions of section 16 of the Securities Exchange Act of 1934 relating to transactions of officers, directors, and controlling persons, which now apply to equity securities of investment companies whose securities are listed on a national securities exchange, are made applicable to all securities of all registered closedend companies.

Section 31. Accounts and records

Subsection (a) authorizes the Commission to require investment companies and certain of their majority-owned subsidiaries to preserve accounts, records, and documents upon which their financial statements filed with the Commission are predicated. Investment advisers, depositors, and principal underwriters of certain investment companies may likewise be required to preserve records showing their transactions with the investment companies with which they are associated.

Under subsection (b), the accounts, records, and documents kept pursuant to subsection (a) are subject at all times to examination by the Commission or its representatives.

Subsection (c) authorizes the Commission to provide for a reasonable degree of uniformity in the accounting policies and principles to be followed by investment companies in maintaining their accounts and records and preparing the financial statements required in their reports to the Commission and stockholders.

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Subsection (d) authorizes the Commission in special cases to grant exemptions from its accounting rules under subsection (c).

Section 32. Accountants and auditors

Under subsection (a), the selection of independent public accountants of investment companies, subject to certain exceptions, must be submitted for ratification or rejection to stockholders who, in addition, at any time by a majority vote may terminate their employment. The auditor's certificate must be addressed to security holders as well as the directors.

Subsection (b) requires that the controller or other principal accounting officer of an investment company be chosen either by the board of directors of the company or by its security holders, and not merely by appointed by its executive officers.

Under subsection (c), the Commission is empowered to require accountants and auditors to keep reports and work sheets and other documents relating to investment companies.

Section 33. Settlement of civil actions

Subsection (a) requires that the documents specified in subsection (b) be transmitted to the Commission if an action or claim for an alleged breach of official duty on the part of an officer, director, investment adviser, trustee, or depositor of an investment company has been compromised with court approval, or if a verdict has been rendered or final judgment entered thereon.

Subsection (b) enumerates the pleadings, written record, and other papers relating to the proceedings which are to be filed. The Commission is authorized to use any information derived from such documents, except the names of the persons concerned, in connection with any report or study which it may make of lawsuits.

Section 34. Destruction and falsification of reports and records.

Subsection (a) prohibits the willful destruction, mutilation, or alteration of accounts and papers required to be preserved pursuant to section 31 (a) or 32 (c).

Subsection (b) contains the usual provisions prohibiting misrepresentations and halftruths in registration statements, applications, reports, accounts, and other documents provided for in the bill. It also imposes a similar responsibility upon accountants and auditors insofar as financial statements and reports signed or certified by them are concerned.

Section 35. Unlawful misrepresentations and names

Subsections (a) and (b) contain the usual provisions prohibiting the misrepresentation of the effect of registration with the Commission.

Subsection (c) makes it clear that subsections (a) and (b) do not prohibit a statement that a person or security is registered, if the effect of such registration is not misrepresented.

The use of misleading names by registered investment companies is specifically prohibited by subsection (d). This prohibition may be enforced by order of the Commission when the name is adopted

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after the effective date of the bill, and by a court at the suit of the Commission as to names theretofore adopted.

Section 36. Injunctions against gross abuse

This section authorizes the Commission to bring an action in a proper court of the United States to enjoin certain affiliated persons and underwriters of investment companies from acting in those capacities, alleging that the defendant or defendants have been guilty of

gross misconduct or gross abuse of trust in respect of the investment company with which he or they are associated. If the allegations are established by evidence before the court, the court is required to enjoin the defendant or defendants for such period of time as appears appropriate to the court. A 5-year statute of limitations is provided. As in the case of noncriminal proceedings which the Commission is authorized to bring pursuant to other sections of the bill, actions under this section are to be brought in the Commission's own name and by its own attorneys.

Section 37. Larceny and embezzlement

Larceny and embezzlement from investment companies registered under this title is made a Federal crime. This provision is in line with similar provisions relating to national banks, interstate carriers, and other institutions subject to comprehensive Federal supervision.

PROCEDURAL, ADMINISTRATIVE, ENFORCEMENT, AND FORMAL PROVISIONS

The remaining provisions of title I, with certain minor exceptions hereinafter noted, closely follow similar provisions in statutes now administered by the Securities and Exchange Commission. All these provisions, as well as the substantive provisions of the bill, have been carefully scrutinized by the members of the industry and their counsel. Section 38: Contains the usual provisions authorizing the Commission to promulgate rules, regulations, and orders in order to carry out its functions under the bill. Subsection (a) of the corresponding section of the original bill has been modified to make it clear that this section does not grant the Commission substantive powers but merely implements powers elsewhere conferred.

Section 39: Provides for publication of the rules and regulations of the Commission.

Section 40: Sets forth, in somewhat more detail than in the statutes now administered by the Commission, the procedures to be followed in the issuance of orders.

Section 41: Provides for hearings by the Commission.

Section 42: Contains appropriate provisions for investigations, injunctive proceedings, criminal references, and other enforcement procedures.

Section 43: Contains the usual provisions for review by the court of order of the Commission.

Section 44: Contains the usual provisions regarding jurisdiction and venue of offenses and suits. To avoid the necessity of bringing

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certain types of criminal proceedings in the District of Columbia, the third sentence of the section contains a special provision making it clear that such proceedings may be brought in the district wherein the defendant is an inhabitant or maintains his principal office or place of business.

Section 45: Provides for confidential treatment of information filed with the Commission, and for the sale by the Commission of copies of information which is available to the public.

Sections 46, 47, and 48: Contain the usual provisions relating to annual reports, validity of contract, liability of controlling persons, and preventing compliance.

Section 49: Contains the penalties for willful violations of the bill.

Section 50: Saving clause for existing laws.

Section 51: Separability clause.

Section 52: Short title.

Section 53: Effective date.

TITLE II. INVESTMENT ADVISERS

Title II of the bill which deals with investment advisers is based on a survey of these organizations by the Securities and Exchange Commission made in connection with its study of investment trusts and investment companies. As in the case of title, I, many of the original provisions of title II were opposed by many investment advisers who appeared at the hearings before the Senate Committee on Banking and Currency. However, at the conclusion of these hearings, the representatives of the Securities and Exchange Commission and those investment advisers who opposed the provisions of the original title II met and as a result of their cooperative endeavors the present title II was drafted. As now drafted, the title has the approval and endorsement of the investment advisers who appeared at the hearings before the committee. In addition, the title is unqualifiedly endorsed by the Investment Counsel Association of America and by a large number of investment advisory organizations which did not testify before the congressional committee.

GENERAL STATEMENT

Investment advisers are persons who for compensation engage in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities or who for compensation and as part of a regular business, promulgate analyses or reports concerning securities. The provision or occupation of investment adviser came into being after the World War and since 1929 the number of individuals and firms engaged in this vocation has increased rapidly. Although it is difficult to determine with precision the amount of public funds administered by investment advisers, some idea of the size of such funds may be deduced from the fact that only 51 firms for which information was available to the Securities and Exchange Commission, managed, supervised, and give investment advice with respect to funds aggregating approximately \$4,000,000,000, a sum roughly equivalent to the entire assets of all investment trusts and investment companies now operating.