



Investment Counsel Association of America

## 1997 ICAA Comments & Statements

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January 10, 1997

Office of Exemption Determinations  
Pension and Welfare Benefits Administration  
Room N-5649  
200 Constitution Avenue, N.W.  
Washington, DC 20210  
Attention: "CIF Conversion Class Exemption"

Re: Application No. D-09988  
Proposed Class Exemption for Bank Collective  
Investment Fund Conversion Transaction  
(the "Proposed Exemption")

To Whom It May Concern:

The Investment Counsel Association of America, Inc. (the "ICAA"), a not-for-profit corporation and national professional association of registered investment adviser firms, appreciates the opportunity to submit these comments on the Proposed Exemption.

#### ICAA Background

The ICAA was founded in 1937 and participated in the legislative process that led to the enactment of the Investment Advisers Act of 1940. Today, the ICAA consists of more than 200 member firms that manage assets aggregating in excess of \$1 trillion for a wide variety of individual and institutional clients. The institutional clients include pension and profit sharing plans, private foundations, public charities, registered investment companies, universities, and other tax-exempt organizations.

Firms which are members of the ICAA agree to observe ethical principles of professional conduct contained in the ICAA's *Standards of Practice*, the hallmark of which is the independence of the investment decision. In brief, the *Standards of Practice* mandate that firms provide clients with continuous, independent, professional, unbiased investment advice, free from conflict of interest. To avoid conflicts of interest, compensation is usually a fee based on a percentage of assets under management, rather than on transactions.

Members of the ICAA include investment advisory firms that are nationally and internationally respected as the leaders of the industry, including firms of various sizes and descriptions throughout the United States. Each ICAA member firm manages client assets in excess of \$25 million and thus will be required to continue to register with the Securities and Exchange Commission in accordance with the provisions of the recently-enacted Investment Advisers Supervision Coordination Act (Title III of the National Securities Markets Improvement Act of 1996, Public Law No. 104-290).

Enclosed herewith is the ICAA's current Directory of Member Firms, which includes the ICAA *Standards of Practice*. The Directory provides a listing of and information on each ICAA member firm.

#### Proposal to Expand the Proposed Exemption

By this letter, the ICAA is requesting that the Proposed Exemption be expanded to include transactions - virtually identical to those covered by the Proposed Exemption - that occur when an investment adviser registered under the Investment Advisers Act of 1940 ("Advisers Act") is an investment manager or investment adviser (a "Plan Fiduciary") to an employee benefit plan ("Client Plan") and also serves as an investment adviser to an investment company registered under the Investment Company Act of 1940 (the "40 Act"). The proposal set forth herein (the "Proposal") would permit a Client Plan to purchase shares of a registered investment company (the "Fund"), managed by a registered investment adviser (the "Adviser") that serves as a Plan Fiduciary of the Client Plan, in exchange for assets of the Client Plan transferred in-kind to the Fund from the Client Plan.

A number of members of the ICAA manage Funds. These Funds have become increasingly popular investments for Client Plan investors. Funds offer certain advantages including: daily pricing and redemption, published prices available in newspapers of general circulation, and greater liquidity. Daily pricing and redemption permit: (a) immediate investment of plan contributions in various types of investments; (b) greater flexibility in transferring assets from one type of investment to another; and (c) faster distributions. Because of advantages offered by Funds, it is expected that many Advisers may wish to convert all or a portion of their directly managed portfolios ("Portfolios") into Funds by transferring the assets out of the Portfolios and into the Adviser's Funds. In some cases it would be expected that Advisers will terminate their Portfolios entirely. In other cases, Portfolios would be partially converted into Funds while a portion of such Portfolios would remain directly managed.

As in the case of the transactions discussed in the Proposed Exemption, the transfer of assets or conversion process contemplated by the Proposal would involve circumstances where the Adviser (representing the Client Plan's interests) would transfer assets of the Client Plan to a Fund managed by the Adviser in exchange for which the Client Plan would receive shares in the

Fund. The in-kind transfers would be subject to the prior approval of Independent Fiduciaries (as that term is defined in the Proposed Exemption) and a number of additional safeguards that are discussed in detail below.

### Application of the Proposal

The Proposal will apply to Advisers that are regulated under Federal law, including the Advisers Act and the 40 Act. Such Advisers may serve as investment managers, as defined in ERISA Section 3(38), or nondiscretionary investment advisers, as described in ERISA Section 3(21), for Client Plans that are subject to ERISA. If an Adviser has investment discretion over the assets of a Client Plan, it commonly manages such assets directly either for a single trust for such Client Plan or for a master trust that holds assets of a number of Client Plans sponsored by a single enterprise or affiliated group of enterprises. An Adviser serving as a nondiscretionary fiduciary may serve any of a broad range of management roles. Whether an Adviser manages on a discretionary or non-discretionary basis, it does so in accordance with a management or investment advisory agreement entered into between it and the Client Plan.

The Proposal will apply to asset transfers and conversion transactions that will be structured as an in-kind transfer of plan assets held by a Client Plan in the Portfolio to the corresponding Funds, in exchange for shares of the Funds. This approach will avoid transaction costs and delays associated with liquidating the securities held in the Portfolios and making the same or similar investments in the Funds.

The ICAA believes it would be desirable to have the Proposal apply both retroactively and prospectively in the same manner set forth in the Proposed Exemption.

### Mechanics of the Proposal

#### A. Structure

Under our Proposal, the process that will be used by Advisers to complete the asset transfer or conversion transaction will be designed to comply with the 40 Act and Prohibited Transaction Exemption 77-4 ("PTE 77-4"), as applicable. In this regard, the Adviser will be required to obtain the approval of an Independent Fiduciary prior to investing in a Client Plan's assets in a Fund. The Independent Fiduciary generally will be the Client Plan's named fiduciary or plan sponsor. In requesting the Independent Fiduciary's approval, the Adviser will be required to provide a description of the transaction, information about each Fund to which the assets would be transferred, and a current prospectus. All disclosures and the form of approval will be designed to meet the requirements of PTE 77-4.

To the extent that the Independent Fiduciary of a Client Plan approves investment in the

Funds, the purchase of Fund shares by the Client Plan, under our Proposal, would be accomplished in accordance with Securities and Exchange Commission Rule 17a-7 ("Rule 17a-7" or the "Rule") under the 40 Act. Rule 17a-7 is an exemption from the prohibited transaction provisions of section 17(a) of the 40 Act, which prohibit, among other things, transactions between an investment company and its investment adviser or affiliates of its investment adviser. Thus, Rule 17a-7 permits transactions between the Funds and other accounts that use the same or affiliated investment advisers, subject to certain conditions that are designed to assure fair valuation of the assets involved in the transaction and fair treatment of both parties to the transaction.

B. Valuation of Securities

Among the conditions of Rule 17a-7 is the requirement that the transaction be effected at the "independent current market price" for the security involved.<sup>1</sup> As discussed in the Proposed Exemption, the "independent current market price" for specific types of securities involved in the transaction will be determined as follows:

(i) If the security is a "reported security" as the term is defined in Rule 11Aa3-1 under the Securities Exchange Act of 1934 (the "34 Act"), the last sale price with respect to such security reported in the consolidated transaction reporting system (the "Consolidated System"); or, if there are no reported transactions in the Consolidated System that day, the average of the highest current independent bid and the lowest current independent offer for such security (reported pursuant to Rule 11Ac1-1 under the 34 Act), as of the close of business on the Portfolio valuation date.

(ii) If the security is not a reported security, and the principal market for such security is an exchange, then the last sale on such exchange or, if there are no reported transactions on such exchange that day, the average of the highest current independent bid and lowest current independent offer on the exchange as of the close of business on the Portfolio valuation date.

(iii) If the security is not a reported security and is quoted in the NASDAQ system, then the average of the highest current independent bid and lowest current

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<sup>1</sup> Rule 17a-7 also includes the following requirements: (a) the transaction must be consistent with the investment objectives and policies of the Fund, as described in its registration statement; (b) the security that is the subject of the transaction must be one for which market quotations are readily available; (c) no brokerage commissions or other remuneration may be paid in connection with the transaction; and (d) the Fund's board of directors (i.e., those directors who are independent of the Fund's investment adviser) must adopt procedures to ensure that the requirements of Rule 17a-7 are followed, and determine no less frequently than quarterly that the transactions during the preceding quarter were in compliance with such procedures.

independent offer reported on Level 1 of NASDAQ as of the close of business on the Portfolio valuation date.<sup>2</sup>

(iv) For all other securities, the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry from at least three independent sources as of the close of business on the Portfolio valuation date.

These valuation conditions are objective and require documentation to permit review by independent parties.

### C. The Transfer Transaction

In each asset transfer or conversion transaction, under the ICAA's Proposal, a portion of the assets in each Portfolio, representing the interests in the Portfolio of the Client Plans that approve the asset transfer, will be transferred to the corresponding Funds using the then-current market value of the Plans' assets in exchange for shares in the Fund. Simultaneously, each Client Plan's investment in the Portfolio will be liquidated and Fund shares of equal value to the Client Plan's interest in the Portfolio will be distributed to the Client Plan.

Prior to such transfers, the Portfolio assets will have to be reviewed to determine whether they are appropriate investments for the corresponding Fund, consistent with the Fund's investment objectives and policies and applicable requirements under the 40 Act and the Internal Revenue Code. In addition, Rule 17a-7 permits transfers only of securities for which market quotations are readily available and does not include restricted securities (such as those described by SEC Rule 144) or other securities for which market quotations are not readily available.<sup>3</sup> If the Proposed Exemption is not expanded as set forth in the Proposal, the transferring Client Plans would be required to request cash distributions, causing the Portfolio to incur delays and higher transaction costs in liquidating a larger proportion of its securities holdings.

In implementing asset transfers under the ICAA's Proposal, the current market value of the assets of the Portfolio's will be determined in accordance with Rule 17a-7 and the procedures adopted by the board of directors of the Fund pursuant to such Rule. The assets will be valued by

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<sup>2</sup> The Application for the Proposed Exemption states the following: (i) Level 1 of NASDAQ provides the best bid and ask quotations for each NASDAQ security that has a minimum of two registered market-makers providing quotations; (ii) Level 2 provides the current bid and ask prices for each market-maker in any available NASDAQ securities, not just the best prices and (iii) Level 3 allows for market-makers instantaneously to insert new quotations into the system and is generally only used by market-makers and traders.

<sup>3</sup> The Adviser has ongoing responsibilities under ERISA's general standards of fiduciary conduct with respect to plans electing to remain as investors in the Portfolio and with respect to other aspects of the transfers.

the Portfolio and the Fund in the same manner using the "independent current market price" of the securities as defined in Rule 17a-7 as of the close of business on the same business day. In addition, no brokerage commissions or other remuneration will be charged to the Client Plans in connection with the asset transfer, as any such cost or expense will be paid by the Adviser.

The ICAA's Proposal would require that the same values be used for the securities, both in determining the amount transferred from the Portfolio and the amount received by the Fund. Thus, the total net asset value of the Fund shares received by the Client Plan will be equal in value to the Client Plan's share of the assets of the Portfolio exchanged for shares of the Fund on the date of transfer.

The valuations will be based on prices, bids, and offers as of the close of business on the date of the asset transfer.

In compliance with Rule 17a-7, the transaction will be reviewed by independent members of the Fund's board of directors and by independent auditors. In this regard, we note that records pertaining to Rule 17a-7 transactions are required to be reviewed by SEC staff during their periodic inspections of the Funds.

Thus, asset transfer transactions under our Proposal will be ministerial in nature because they will be performed in accordance with procedures that are prescribed by Rule 17a-7 and approved by a Fund's board of directors. Further, the pricing of all securities transferred to a Fund will be accomplished by reference to independent sources. In each case, the affected Client Plans will receive shares of the Funds that are of equal value to the previously-held Portfolio units.

### Conclusions

The Proposal set forth herein offers Client Plans the same advantages as the Proposed Exemption with substantially the same safeguards. Failure to expand the Proposed Exemption in accordance with the Proposal will disadvantage Client Plans managed by investment advisers by favoring Client Plans that are managed by banks. Indeed, the Proposed Exemption would cover investment advisers affiliated with banks while excluding other investment advisers. Unless the Proposed Exemption is modified to include the ICAA's Proposal, Client Plans managed by investment advisers that are not affiliated with banks would not be permitted to complete transactions essentially identical to those discussed in the Proposed Exemption. Effectively, such Client Plans would be required to sell securities and incur additional delays and transaction costs, whereas Client Plans with banks (or their affiliates) as Plan Fiduciaries would not have such burdens. This is not only inconsistent with the best interests of the Client Plans but would put investment advisers at a competitive disadvantage to banks.

The only operating difference the ICAA is able to identify with respect to the Proposed Exemption as applied to an Adviser is that generally an Adviser will be a fiduciary to a Client Plan or a master trust for a number of Client Plans sponsored by an enterprise or an affiliated group of enterprises that sponsor those Client Plans and, accordingly, the pro-rata allocation of assets would be unnecessary. Under our Proposal, in-kind transfers would be made with assets selected by the Adviser, based upon the appropriate portfolio mix of the client account desired following the transaction. The in-kind transfers contemplated by the Proposal will be in compliance with the 40 Act and the Advisers Act, in light of their compliance with Rule 17a-7, the Adviser's determination (consistent with its fiduciary duty under those Acts) that the transaction is consistent with the best interests of both the Client Plan and the Fund, and the disclosure made to both the Fund board of directors and an Independent Fiduciary for the Client Plan.

With respect to any public hearings on the Proposed Exemption, the ICAA hereby requests that:

- (a) there be a public hearing if the Department decides to issue a Final Exemption in the form of the Proposed Exemption without expanding it in accordance with the Proposal; and
- (b) if any such public hearing is held with respect to the Proposed Exemption, the ICAA be permitted to appear and testify at such hearing.

Office of Exemption Determinations  
January 10, 1997  
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If the Department should have any comments or questions regarding these comments or the Proposal, please contact the undersigned or ICAA legal counsel, Roger C. Siske [312-876-8018] or Paul J. Miller [312-876-8074], at Sonnenschein Nath & Rosenthal.

Sincerely,

Investment Counsel Association of America, Inc.

By:

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Enclosure (ICAA Directory of Member Firms, October 1996)

# INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.

1050 17th Street, N.W., Suite 725 • Washington, D.C. 20036 • (202) 293-ICAA • FAX (202) 293-4223

February 10, 1997

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
430 Fifth Street N.W., Stop 6-9  
Washington, DC 20549

**Re: Release IA-1601, File No. S7-31-96 (the “Release”) -- Rules (“Proposed Rules”) Implementing the Investment Advisers Supervision Coordination Act (“Coordination Act” or “Act”).**

Dear Mr. Katz:

The Investment Counsel Association of America, Inc. (“ICAA” or “Association”) appreciates the opportunity to comment on the Proposed Rules. Particularly given the complexity and scope of changes required by the Coordination Act, we commend the staff for its prompt and thorough treatment of relevant issues. Overall, the ICAA believes the initial proposal is an excellent starting point for discussion and, subject to modifications suggested below, supports the Proposed Rules.

## **The ICAA**

The ICAA is a national professional association consisting exclusively of independent investment advisory firms. Founded in 1937, the ICAA played a major role in shaping the Investment Advisers Act of 1940 (the “Advisers Act”). Over the years, the Association has represented the investment advisory industry in various legislative and administrative matters at both the Federal and state level, including recent Congressional deliberations culminating in the enactment of the Coordination Act. Today, the Association consists of more than 215 member firms located throughout the United States that collectively manage funds in excess of \$1 trillion for a wide variety of institutional and individual clients. All member firms subscribe to the ICAA’s *Standards of Practice*, the hallmark of which is independence of investment decision and freedom from conflict of interest with clients. All ICAA member firms manage client assets in excess of \$25 million (approximately one-half of our member firms manage assets of between \$100 million and \$1 billion, and approximately one-half of our member firms manage assets in excess of \$1 billion).

## **Legislative Intent and History -- Overview**

Enactment of the Coordination Act clearly evidences an intent by Congress to eliminate burdensome, overlapping, and frequently inconsistent regulation of investment adviser firms and the individuals who work for and on behalf of such firms. As the name Act itself implies, Congress

sought to create a new and improved scheme of regulation that *coordinates* regulation of investment advisory firms and their employees by allocating responsibility for larger firms that operate in interstate commerce to the Commission and allocating responsibility for smaller firms and individual financial planners to the states. This critically-important overriding legislative intent is summarized eloquently in the "Background" section of the Proposed Rules (Release, pp. 5-6):

The reallocation of regulatory responsibilities grew out of Congress' concern that the Commission's resources are inadequate to supervise the activities of the growing number of investment advisers registered with the Commission, many of which are small, locally operated, financial planning firms. Congress concluded that if the overlapping regulatory responsibilities of the Commission and the states were divided by making the states primarily responsible for smaller advisory firms and the Commission primarily responsible for larger firms, the regulatory resources of the Commission and the states could be put to better, more efficient use.

Congress also was concerned with the cost imposed on investment advisers and their clients by overlapping, and in some cases, duplicative, regulation. In addition to the Commission, forty-six states regulate the activities of investment advisers under state investment adviser statutes. States generally have asserted jurisdiction over investment advisers that "transact business" in their states. Consequently, many large advisers operating nationally have been subject to the differing laws of many states. Compliance with differing state laws had imposed significant regulatory burdens on these large advisers. *Congress intended to reduce these burdens by subjecting large advisers to a single regulatory program administered by the Commission.* (emphasis added.)

The ICAA strongly agrees with these statements and notes they are supported further by numerous statements found in the legislative history accompanying passage of the Coordination Act. For example, during consideration of the conference report, Sen. D'Amato stated that:

This legislation will tighten up regulation by giving the States and the SEC distinctly separate regulatory roles. It will divide between the SEC and the States regulation of the 22,000 registered investment advisers who are entrusted with \$10.6 trillion in customer funds -- much of which represents savings and retirement money. As a result, investment advisers will be better regulated and consumers and investors better protected. (142 *Cong. Record*, S. 12093, October 1, 1996)

Sen. Dodd similarly noted that the Coordination Act "improves the regulation of investment advisers by clarifying the proper roles of the SEC and the State regulators." (142 *Cong. Record*, S. 12094, October 1, 1996). Rep. Bliley noted that the "legislation will eliminate unnecessary regulatory burdens and the costs that they impose on American business and investors" and Rep. Fields stated that the bill will "end regulation in its duplicative sense that is needless and costs

money wastefully.” (142 *Cong. Record*, H. 12047-12049, September 28, 1996).

The Coordination Act’s reallocation of regulatory responsibility over investment advisers is an historic development. It addresses the needs of increasing investor protection, while reducing the costs of overlapping and inefficient regulation. These are goals that the Commission and the ICAA supported throughout development of the Coordination Act. Against that background, our comments are directed at a few provisions of the Proposed Rules we believe merit further discussion and review.

### **I. The Limited Exception for State Authority Over Investment Adviser Representatives**

The Coordination Act *expressly* preempts state laws governing registration, qualification and licensing of larger advisers: “No law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser shall apply...” (Section 203A(b), Advisers Act). Congress provided only one limited exception (the “Exception”) to such Federal preemption: “a State may license, register, or otherwise qualify any investment adviser representative who has a place of business located within that State.” (Section 203A (b)(1)(A), Advisers Act). The ICAA requests that the Commission reconsider its Proposed Rules regarding the Exception to establish a “bright line” test with two primary components: (1) “investment adviser representative” should be defined to mean a representative of a large, SEC-registered firm who provides investment advice almost exclusively to non-sophisticated investors, and (2) “place of business located within that State” should be interpreted in accordance with its plain meaning -- an office (usually leased or purchased) of the large adviser firm from which the firm provides advisory services. Such an interpretation would give effect to what Congress intended: broad Federal preemption of state registration, qualification, and licensing laws for larger investment advisers and their employees, except in those limited situations where uniquely local concerns are involved.

#### **A. Place of Business Located Within That State**

The Proposed Rules define “place of business of an investment adviser representative” as “a place or office from which the investment adviser representative regularly provides advisory services or otherwise solicits, meets with, or communicates to clients, *unless* the investment adviser representative does not regularly provide advisory services or otherwise solicit, meet with, or communicate to clients at any place or office, in which case the place of business of such investment adviser representative will be the residence of each client.” (Release, p. 65.) In our view, the proposed definition is overly broad and extends state authority beyond the plain meaning of the Coordination Act.

When S. 1815 was passed by the Senate, it provided Federal preemption of regulation of larger investment advisers. The Exception was added in the final conference report. While we agree that the Exception evidences Congressional intent to give states some authority over a limited

class of “supervised persons,” we believe the proposed definition goes well beyond the plain meaning of “place of business located within that State.” It transforms “place of business” into “any regular contact with clients,” wherever that contact occurs, *even in the home of a client* (Release, p. 35). The proposed definition invites continuing disparate state-by-state treatment by failing to define what “regularly” means (*e.g.*, do the Proposed Rules intend to cover regular annual meetings in the home of a client, even if the adviser representative has no office in the state where such meetings occur?). Even worse, the Proposed Rules *deem* the residence of any client to be an office or place of business, even where no regular client contact occurs.

We respectfully submit that “place of business” should be given its “most natural or logical” meaning. *See, Securities and Exchange Commission v. Sloan*, 436 U.S. 103, 111, 98 S.Ct. 1702, 1708 (1978). A place of business does not mean “many places of business.” Nor is a place of business “any place within a state where an adviser meets his client.” A place of business usually and ordinarily is read to imply a degree of permanence, an office or other physical place (usually leased or purchased) in the state regularly used as a base for doing business -- not the stops on the route of the itinerant salesman (or visiting adviser). If the Exception was intended to cover such itinerant advisers, we submit that Congress certainly would have drafted vastly different language from what was enacted.

The word “located” in the Coordination Act throws further light on the meaning of “place of business.” In terms of a business, the dictionary (*Webster’s Encyclopedia Unabridged Dictionary* (1994 Ed.)) defines “locate” as follows:

. . . to establish oneself, one’s business, or one’s residence *in a place; settle . . .*  
(emphasis added.)

The dictionary reference is to “establishing” (itself a word connoting permanence, not visitation), to “a place” where that establishment takes root, not to multiple places; and to “settl[ing]” (again a word connoting permanence).

In effect, the definition of “place of business” in the Proposed Rules creates a “doing business” type of test. Had Congress intended to create a “doing business” test, it could have done so. We note that the Release addresses this issue and we agree with the conclusion reached (p. 36):

*Interpreting “place of business” as the equivalent of “doing business” would have the effect of nullifying the restriction that “place of business” places on a state’s authority to regulate investment adviser representatives. In the Commission’s view, Congress could not have intended this result, or it would not have included the place of business clause in Section 203A(b)(1)(A).* (emphasis added.)

Yet that nullification is precisely what will occur if the proposed definition is adopted.

We also note that the proposed definition of “place of business located within that State” extends the power of the states far beyond the limited local concerns the states asked Congress to recognize. In testimony before the Senate Committee, as cited by the Commission (Release, footnote 68), the North American Securities Administrators Association (“NASAA”) told Congress:

Of particular concern to the states is the potential loss of licensing authority over [investment adviser representatives] associated with [advisory] firms *operating out of small branch offices* nationwide. Typically, a small number of [investment adviser representatives] operate out of *each office providing, almost exclusively, retail* investment advisory services. . . . Because of the *local nature* and retail clientele of these [representatives], the states have a strong interest in maintaining oversight of them. (emphasis added.)

The states told Congress they were concerned about investment adviser representatives operating out of *branch offices* providing “almost exclusively retail investment advisory services.” Congress fashioned a limited exception to the general rule of Federal preemption to accommodate that uniquely local concern. The express concern was “office” and that is what Congress meant by “a place of business located within that State.”

We respectfully request the Commission to review the proposed definition of “place of business” and to modify it so that it more accurately reflects the limited situations intended to be covered (*i.e.*, where an investment adviser representative provides advisory services to “retail” clients from an established office).

Following are two examples drawn from a typical operation of some of our member firms that may serve to demonstrate how the definition of “place of business,” as set forth in the Proposed Rules, could lead to undesirable and unintended results:

1. Investment adviser A maintains its office in Chicago. Individual X is an officer of A and is regularly employed in A’s office in Chicago. Individual X advises a number of natural person clients (and, therefore, falls within the proposed definition of an “investment adviser representative”), and a number of corporate pension fund clients. X, as a responsible portfolio manager, attends regular meetings with each client. One pension fund client, located in Los Angeles, has most quarterly meetings at its offices, but twice a year has a golf outing at a local golf course, where each of its several investment managers participates. Another client is in New York City, and generally has its quarterly investment manager meetings at a restaurant in Manhattan, but twice a year has a meeting at a hotel in Massachusetts in connection with company management meetings. A third client is in Hartford, Connecticut, and generally has its meetings with investment managers at its offices, but at least once per year the meeting occurs in a hotel in Florida, near where the

company chairman has a winter home. The company chairman is also a client of A, and X regularly has dinner with the chairman at the chairman's home (either in Hartford or Florida) the night before each of the pension fund's quarterly meetings to review the chairman's personal portfolio.

Under the Proposed Rules, X could be deemed to have a "place of business" at each of the following locations: 1) the California client's office; 2) the Los Angeles golf course; 3) the Manhattan restaurant; 4) the Massachusetts hotel; 5) the Connecticut client's offices; 6) the Florida hotel; 7) the company chairman's home in Hartford; and 8) the company chairman's home in Florida. Interestingly, a total of 4 clients results in the adviser representative, X, being deemed to have no less than 8 places of business, in 5 different states.

2. X also has a number of natural person clients with whom he meets approximately every 6 months. These clients live in the Chicago area, and generally come to A's office to meet with X. One client, however, has a winter home in Phoenix, Arizona, and X regularly travels to Phoenix at least once a year to meet with that client at the client's winter home. Under the Proposed Rules, X also may have a "place of business" in Arizona, at the client's winter home.

Note that X actually does have a "place of business" in the plain meaning -- at A's offices in Chicago -- and would be subject to licensure or qualification in Illinois as a result. Note also that the absence of any definition of what is a "regular" meeting lends itself to differing state interpretations, creating the uncertainty and inconsistency that the Act was intended to eliminate. One can well wonder why X also may be subject to licensure or qualification in each of the other jurisdictions in which he sometimes meets with his clients. We respectfully suggest that this is exactly the kind of duplicative regulation and waste of resources that the Coordination Act was intended to remedy.

The Commission should not change the clear, intended meaning of "a place of business located within a State" -- it means an office within the state from which the investment adviser regularly provides advisory services or otherwise solicits, meets with, or communicates with clients.<sup>1</sup>

## **B. Investment Adviser Representative**

As the Commission observes (Release, p. 30), testimony on behalf of the states in support

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<sup>1</sup>Consistent with this view, the place of business of an investment advisory representative providing advisory services or soliciting clients through a web-site would be the office from which such representative conducts his or her business.

of state regulation of investment adviser representatives of large advisers was premised on the perceived need to protect “retail” investors (*see*, testimony of NASAA above and the following testimony of Dee R. Harris, cited at Release, footnote 68):

NASAA recommends . . . requiring all supervised persons that provide advice to retail clients to be licensed with the states regardless of the size of their [advisory] firm. Supervised persons would be exempt from state licensure if they do not solicit *retail business* nor hold themselves out as providing investment advice to a *retail clientele*. (emphasis added.)

Recognizing that as Congress’ intent, the ICAA strongly supports the concept proposed by the Commission that would permit state regulation only where “a substantial portion of the business of the supervised person is providing investment advice to clients who are natural persons.” (Release, p. 64.) However, as noted below, we believe the Proposed Rules should be amended to exempt sophisticated clients from the definition of “natural person.” Further, we believe the current definition of “substantial portion” (10% of assets or clients) really reflects a *minimal* portion and instead should be defined to mean 25% or more of the investment adviser representative’s clients or assets under management.

### **1. A Sophisticated Investor is Not a Retail Client**

There are many instances where the Federal securities laws treat high net worth individuals differently from lower-income, non-sophisticated investors. For example, Regulation D under the Securities Act of 1933 (“’33 Act”) exempts from registration under the ’33 Act transactions with an “accredited investor,” defined to include any natural person whose net worth, or joint net worth with spouse, exceeds \$1,000,000 or whose income, and expected income, or joint income with spouse, over a number of years exceeds \$200,000 (Regulation D, Rule 501(a)(5) and (6)). Such investors long have been regarded by the Commission (and by most states) as sufficiently sophisticated to be able to make their own investment decisions. Certainly, such investors are sophisticated enough to choose an adviser to make investment decisions for them. We believe this concept should be included explicitly in the definition of “investment adviser representative,” by incorporating the definitions of Rule 501(a)(5) and (6) under the ’33 Act as exceptions to the definition of “natural person.”

A similar high net worth standard is used with respect to an adviser’s use of performance fees under the Advisers Act and such standard could be adopted as an alternative to the “accredited investor” standard in Regulation D. Rule 205-3(b)(1) of the Advisers Act defines the financial sophistication of a natural person in terms of assets managed: (1) at least \$500,000 presently under management *or* (2) a net worth, including joint assets of a spouse, in excess of \$1,000,000. However, unlike Regulation D, Rule 205-3(b) does not recognize an income standard and we submit that Regulation D therefore is a more appropriate exemption from the definition of “natural person.” As noted above, if an investor at the net income levels required under Rule 501(a)(5) does

not need protection under the Federal securities laws in making investment decisions (whatever the amount), such an investor also should be exempt explicitly from state regulation with respect to simply choosing a Commission-registered investment adviser.

## **2. Substantial Portion of Business**

Proposed Rule 203A-3(a)(1) defines an investment adviser representative as:

. . . a supervised person of the investment adviser if a substantial portion of the business of the supervised person is providing investment advice to clients who are natural persons.

Proposed Rule 203A-3(a)(2)(ii) then defines “substantial portion of the business” as follows:

(ii) A substantial portion of the business of a supervised person is providing investment advice to clients who are natural persons if, during the course of the preceding 12 months:

(A) Clients who are natural persons represented more than 10 percent of the clients of the supervised person; or

(B) Assets of clients who are natural persons represented more than 10 percent of the assets under management attributable to the supervised person.

As an initial matter, the proposed definition can be construed to relate to investment advice provided by the supervised person to *all* of his or her clients who are natural persons in *every* state. If this interpretation is correct, a supervised person with natural person clients in *all* states exceeding 10% of the *total* number of his or her clients would be required to register in a single state in which he or she has a place of business (even if the natural person clients or assets under management amount to less than 10% of the supervised person’s clients or assets under management in a particular state). The proposed definition, therefore, would permit state regulation far beyond the Act, which instead refers to “any investment adviser representative who has a place of business located within *that* State.” We urge the Commission to modify the proposed definition to make it clear that the measuring standards apply to clients or assets *within a single state* where the large adviser has a permanent office.

Further, we agree with the concept of requiring that a “substantial portion” of a supervised person’s business is providing advice to natural persons, but we strongly believe the proposed definition of “substantial portion” (10% of natural person clients or assets) is inadequate. We regard 10% as a definition of “minimal,” not “substantial.” We urge the Commission to reconsider the “substantial portion” definition to comport more accurately with what one ordinarily perceives as “substantial.” We suggest that the Commission replace 10% with “more than 25%.”

While we believe that “substantial portion of the business” is best measured by the percentage of assets under management attributable to the supervised person in any particular state, we understand that the percentage of clients test also represents a reasonable approach and would not disagree with the Commission’s adoption of such a standard. In any event, we believe the final rules should embrace a *single* standard.

Finally, we respectfully provide the following technical observations on whatever measuring standard is adopted:

- (1) Provision should be made to exclude wrap-fee clients (and/or their assets under management) from any calculation of “substantial portion,” whenever, as is often the case, the broker -- not the adviser -- is the primary contact with the *client*; and
- (2) A finite period over which the measuring standard applies should be specified, *e.g.*,
  - a “look-back” over the previous calendar year. We believe the Commission should avoid linking the investment adviser representative’s regulatory status to day-to-day changes and fluctuations in such representative’s number of clients or assets under management.

## **II. State Regulation of Non-Fraudulent Practices**

We strongly agree with the following statement in the Commission’s Release (p. 10):

States may not, however, indirectly regulate activities of Commission-registered advisers by enforcing state requirements that define “dishonest” or “unethical” business practices unless the prohibited practices would be fraudulent absent the requirements.

The Commission correctly recognizes that it would be inconsistent with the provisions and purposes of the Coordination Act to permit continued state regulation of various business practices of larger investment advisers under the guise of anti-fraud authority. We read the Commission’s statement to extend to a variety of activities covered by Federal regulations, including requirements concerning: books and records; inspections; performance fees; custody; conflicts of interest; solicitation; advertising; review and filing of marketing materials; and other similar rules the Commission has adopted. Otherwise, the very problems the Congress intended to address for SEC-registered investment advisers and investment adviser representatives – duplicative, inconsistent, and overlapping regulation -- will remain.

Similarly, the Commission proposes (Release, p. 43) to amend Rule 205-3 (relating to performance fee arrangements) “to make the exemption applicable to all advisers, including those

registered only under state law after April 9, 1997.” We support the conclusion reached, but believe the Commission should further clarify this by explicitly stating that such rule is the *exclusive* standard for performance fees and that it preempts any state laws or regulations that address the use of performance fees.

### **III. Solicitors**

We believe the Commission’s discussion of “solicitors” unnecessarily introduces an element of confusion. The Release (p. 37) recognizes that, in the case of Commission-regulated advisers, state regulation is preempted with respect to “supervised persons,” as defined in Section 202(a)(25) of the Advisers Act:

...any partner, officer, director (or other person occupying a similar position or performing similar functions) or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.

However, the Release goes on to state that a solicitor may not provide investment advice and, therefore, is *not* a “supervised person.” We believe this misconstrues the statute’s definition of “supervised person.” We read the final clause in the definition of “supervised person” -- “and is subject to the supervision and control of the investment adviser” -- as modifying *all* persons previously identified in the definition, *not just* a “person who provides investment advice on behalf of the investment adviser.” Under the proper interpretation of the definition, if the person is subject to the supervision and control of the investment adviser (whether the person is a partner, officer, director, *or* other person occupying a similar position or performing similar functions; *or* an employee; *or* other person who provides investment advice on behalf of the investment adviser), the person falls within the definition of “supervised person.” In other words, a solicitor who is subject to the supervision and control of the investment adviser is a “supervised person” and should be accorded the same treatment under the Coordination Act as all other supervised persons.

### **IV. Control**

Proposed Rule 203A-2(c) exempts from the Act’s prohibition against Federal registration an investment adviser controlled by an investment adviser eligible to register with the Commission. But it adds a requirement that the principal office and place of business of the “controlled” adviser be the same as that of the registered adviser. In our opinion, congruence of principal offices and places of business is not an appropriate criterion. We believe an investment adviser that is under the control of an SEC-registered investment adviser also should be regulated by the Commission.

## **V. Additional Comments**

Following are miscellaneous suggestions and comments on other sections of the Proposed Rules:

### **A. Grace Periods**

Since many start-up advisers, whether created by spin-off or otherwise, may need time to get the approval of boards of directors, pension committees, or trustees of institutional clients to confirm a decision to retain the adviser, we believe the proposed 90-day period (Release, p. 25) may be inadequate and instead suggest a 120-day period. In a similar vein, we view a grace period of 120 days as more reasonable to permit an adviser that becomes Federally-ineligible to register with the states.

### **B. National De Minimis Standard**

We support the attempt to define "client" so as to create the uniformity of treatment sought by Congress and we generally agree with the definitions of Proposed Rule 222-2. In light of the increasing complexity of economic arrangements of today's families, we suggest that the Commission might consider treating as a single client: (1) all family members, whether or not sharing the same house; (2) a natural person and a revocable trust of which such person is grantor, regardless of currently-designated beneficiaries; and (3) a natural person and an IRA account of which such person is the depositor, regardless of currently-designated beneficiaries. In the interest of uniformity, we would support a conclusion that whatever definition of "client" is adopted under Proposed Rule 222-2 also be adopted for purposes of Section 203(b)(3) of the Advisers Act. To accomplish that, we see no need to revise Rule 203(b)(3)'s "safe harbor" definition of a limited partnership as "client."

### **C. Form ADV-T**

Instruction 7. The proposed instruction (Release, pp. 79-80) properly states the general principle relevant to whether an adviser providing ongoing management or supervisory services on a non-discretionary basis is providing continuous and regular supervisory or management services. However, we are concerned that footnote 33 in the Release will be read to undercut the importance of frequency of contact. We believe that frequency of trading, reporting, and contact is the key element in the factual analysis and we believe that should be so stated.

## **Conclusion**

The ICAA appreciates the opportunity to comment on the Proposed Rules. We strongly believe Congress recognized the current burdens, costs, and inefficiencies caused by overlapping and inconsistent regulation of larger advisers that operate in interstate commerce. To solve those

problems, Congress enacted a law that allocates regulatory responsibility over large advisers to the Commission and away from the states. The law *expressly* preempts state laws requiring registration, qualification, and licensing of larger adviser firms. The narrow Exception for investment adviser representatives who have a place of business located within a state should not be construed or implemented in a manner that would eviscerate the express preemption in the law. Unfortunately, the Proposed Regulations would undercut the stated premise of the law by forcing numerous employees of large adviser firms to be subjected to state registration, qualification, and licensing requirements.

In defining the Exception, the Proposed Rules fail to recognize the clear Congressional intent of allocating regulatory responsibility for large and small advisers between the Commission and the states, respectively. The Proposed Regulations, if implemented, would have the absurd result of exempting large adviser *firms* from state registration, qualification, and licensing requirements, while extending such state requirements to *any employee* of such firm who provides advice outside of the state in which the firm has an office. By not providing a “bright line” test in this one important area, the Proposed Regulations result in overly-complicated and subjective criteria that will create unnecessary uncertainty and impose burdensome costs on larger adviser firms, their employees, and the clients they represent.

The ICAA historically has supported reasonable and rational regulation of its member firms by the Commission. The ICAA consistently has testified before Congressional committees and written numerous letters through the years urging the Congress to provide appropriate levels of resources to the Commission to carry out its regulatory responsibilities. Under the new and vastly-improved scheme of regulation envisioned by the Coordination Act, the ICAA will continue to support adequate resources for the Commission in order to achieve the goal of improved oversight of larger investment advisers, as noted in Chairman Levitt’s statement at the December 18 voting conference:

The 1996 Act provides the states with the paramount role in overseeing the small investment advisers. Much has been made of how the 1996 Act pre-empted state regulation in many areas, but in the small adviser area, the Act’s approach is just the opposite. The Commission will step aside and defer to the states in the oversight of small advisers, where it’s clear that they can do a more effective job. *At the same time, the Commission’s resources can be devoted to the large advisers that have national business.* (emphasis added.)

The ICAA stands ready to provide the Commission and its staff with any information that may be helpful to ensure that the Coordination Act’s allocation of regulatory responsibility between the Commission and the states is implemented appropriately, as Congress clearly intended.

Sincerely,

Mr. Jonathan G. Katz  
February 10, 1997

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THE INVESTMENT COUNSEL ASSOCIATION  
OF AMERICA, INC.

by:

DAVID G. TITTSWORTH  
Executive Director  
Executive Vice President

August 20, 1997

*By Facsimile and U.S. Mail*

Mr. Neil E. Sullivan  
Executive Director  
Ms. Karen O'Brien  
General Counsel  
NASAA  
One Massachusetts Ave., N.W.  
Suite 310  
Washington, D.C. 20001

Re: National Database for Investment Advisers

Dear Neil and Karen:

Thank you for including the ICAA in your August 1 teleconference regarding a national database for investment advisers. This letter responds to your request for comments during that call.

The ICAA generally supports the concept of a one-stop filing system for investment advisers. As we see it, such a system should allow an SEC-registered adviser to file Form ADV and any amendments in only one place. The filing would be transmitted efficiently to the SEC and to those states with which the adviser must notice file. Such a system also should include a mechanism for fee transmittal, so that advisers would not have to make any separate mailings to the various states. Similarly, the system should permit investment adviser representative registration with the states using only one uniform filing. Finally, the system should provide an easy and accurate method for investors to check on the disciplinary history of investment advisers.

To achieve any of the efficiencies of a one-stop filing system, however, the system must truly be "one-stop." We thus are troubled by the seemingly parallel, yet uncoordinated, efforts to craft a national database on the part of both NASAA and the SEC. We oppose the notion that SEC-registered investment advisers should have to work with two systems, one created by NASAA and the other created by the SEC. Such a result would not only burden investment advisers, but also would be cumbersome for investors, who would have to research two separate sources to check on disciplinary history.

In the National Securities Markets Improvement Act of 1996 (NSMIA), Congress directed the SEC to develop a national database to provide investors with better access to disciplinary information about investment advisers.<sup>1</sup> Congress also authorized the SEC to develop a filing depository for investment adviser filings.<sup>2</sup> We understand the SEC will follow that congressional mandate by developing a one-stop filing system for advisers that can be used as a database for investors. Given that the SEC will move forward with such a system, we believe it is critical that NASAA work with the SEC to develop a coordinated system that is truly “one-stop” for both investors and investment advisers.

Finally, we have significant concern about the costs of creating and maintaining a one-stop filing system. We assume NASAA shares our view that one of the virtues of such a system is its potential to increase efficiencies while *reducing* costs associated with the current scheme. At a minimum, we hope the SEC and NASAA will work together to create a database and filing system without imposing additional fees on investment advisers. Our support for a one-stop filing system thus is conditioned on learning more about whether there will be substantial costs that could outweigh the benefits of the system.

Thank you for considering our comments. Please do not hesitate to call me or David Tittsworth, Executive Director, if you have any questions.

Sincerely,

Karen L. Barr  
General Counsel

cc: Barry Barbash, Director, SEC Division of Investment Management  
Robert E. Plaze, Associate Director, SEC Division of  
Investment Management

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<sup>1</sup> Section 306 of the Investment Advisers Supervision Coordination Act refers to the disciplinary history of “investment advisers,” rather than “registered investment advisers.” It is unclear whether this section will be interpreted to require the SEC to provide investors with the disciplinary history of state-registered investment advisers in addition to federally-registered investment advisers.

<sup>2</sup> Section 203A(d) of the Investment Advisers Act of 1940.

## **Statement of The Investment Counsel Association of America DOL ERISA Advisory Council Working Group on Soft Dollars**

The Investment Counsel Association of America (ICAA) respectfully submits this written statement for the record in connection with the meeting to be held on September 17, 1997 by the DOL ERISA Advisory Council's Working Group on Soft Dollar Arrangements and Commission Recapture.

The ICAA is a national not-for-profit association that exclusively represents federally registered investment advisory firms. Our membership consists of more than 215 investment advisory firms that collectively manage funds in excess of \$1 trillion for a wide variety of institutional and individual clients, including employee pension plans. Approximately one-half of ICAA's member firms manage assets of between \$100 million and \$1 billion and approximately one-half of our member firms manage assets in excess of \$1 billion.

### Background<sup>1</sup>

On May 1, 1975, the SEC abolished fixed commission rates. Prior to that time, because brokers could not compete based on brokerage rates, they offered additional services to investment advisers, such as research, administrative, and other services. Other arrangements, such as commission recapture, also arose from brokers' attempts to compete for business. After fixed commission rates were eliminated, fiduciaries were concerned that they would be required under federal and/or state law to execute

transactions at the lowest possible commission rate, in effect precluding them from obtaining research services with commission dollars. Such an interpretation, it was feared, would result in smaller advisers being unable to obtain necessary research and in the reduction of the amount and quality of research available.

In response to these concerns, Congress enacted Section 28(e) of the Securities Exchange Act of 1934. Section 28(e) provides a safe harbor for fiduciaries to use commissions generated by their clients' accounts to obtain brokerage and research services from broker-dealers as long as various conditions are met. Section 28(e) provides that a person who exercises investment discretion over an account will not be deemed to have acted unlawfully or to have breached any fiduciary duty solely by causing client accounts to pay more than the lowest possible commission rates if that person determines in good faith that the amount of the commission is reasonable relative to the value of the brokerage and research services obtained. Thus, fiduciaries in compliance with Section 28(e) do not breach ERISA fiduciary duty rules or other federal and state laws that would otherwise apply to soft dollar transactions that are within the scope of Section 28(e).<sup>2</sup> Although Section 28(e) is only a safe harbor and a fiduciary may act outside its protection under certain circumstances without violation of law, Section 28(e) serves in effect as the principal guidance pursuant to which soft dollar arrangements are conducted.

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<sup>1</sup> The source of much of this background section is Thomas P. Lemke and Gerald T. Lins, *Soft Dollars and Other Brokerage Arrangements* (1997-98 Edition).

<sup>2</sup> See Section 28(e) of the Securities Exchange Act of 1934; see also Thomas P. Lemke and Gerald T. Lins, *Soft Dollars and Other Brokerage Arrangements* (1997-98 Edition) at 50.

The SEC has the exclusive authority to interpret Section 28(e). Pursuant to that authority, the SEC has provided guidance regarding permissible soft dollar arrangements.<sup>3</sup> The SEC also has developed specific disclosure requirements concerning soft dollar usage, including requirements for investment advisers to disclose certain information about such arrangements in the brochure they provide each client, *including pension plans and other ERISA clients*.<sup>4</sup> In 1986, the SEC issued an extensive release discussing interpretive issues surrounding Section 28(e).<sup>5</sup> One month later, the DOL's Pension and Welfare Benefits Administration issued its own interpretive release discussing the application of ERISA's fiduciary responsibility and prohibited transaction provisions to soft dollar and directed brokerage issues.<sup>6</sup> The DOL release, which was fairly consistent with the SEC's release, did not interpret Section 28(e), stating that the SEC "administers the 1934 Act and has *exclusive authority* to interpret the scope of Section 28(e) and the terms used therein."<sup>7</sup>

In recognition of the SEC's authority in this area, the DOL has requested the SEC's guidance in determining the applicability of Section 28(e) to commission practices

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<sup>3</sup> See, e.g., *Interpretations of Section 28(e) of the Securities Exchange Act of 1934; Use of Commission Payments by Fiduciaries*, Rel. No. 34-12251 (Mar. 24, 1976); *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Rel. No. 34-23170 (Apr. 23, 1986).

<sup>4</sup> SEC Form ADV, Part II, Items 12 and 13; Rule 204-3 under the Investment Advisers Act of 1940.

<sup>5</sup> *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Rel. No. 34-23170 (Apr. 23, 1986).

<sup>6</sup> *Statement on Policies Concerning Soft Dollar and Directed Commission Arrangements*, ERISA Technical Release No. 86-1 (May 22, 1986).

<sup>7</sup> *Id.* at 1.

related to ERISA accounts.<sup>8</sup> For example, the DOL requested the SEC to advise it whether the use of soft dollars for the correction of trading errors fell within the safe harbor of Section 28(e). The SEC issued an interpretive letter to the DOL advising that such usage was not within the Section 28(e) safe harbor.<sup>9</sup>

Currently, the SEC staff is drafting a comprehensive report to the SEC Commissioners describing soft dollar practices in the securities industry. It is expected to be released shortly. The report will be based primarily on information received during extensive fact-finding examinations of the soft dollar practices of approximately 300 brokerage and investment advisory firms. The report most likely will include recommendations for improved regulation of these practices, including revisions to current disclosure requirements. The SEC also is in the process of revising Form ADV, the principal disclosure document for investment advisers, and may well revise the section in that document requiring soft dollar disclosure.

### Discussion

We understand that the ERISA Advisory Council's Working Group on Soft Dollar Arrangements and Commission Recapture is considering whether to recommend that the DOL impose additional disclosure requirements regarding soft dollar practices. The ICAA respectfully requests that, instead, the Working Group recommend that the DOL provide input to, and consult with, the SEC regarding disclosure and other soft dollar requirements. The SEC recently conducted exhaustive research on soft dollar

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<sup>8</sup> See *Department of Labor (Charles Lerner)*, SEC No-Action Letter (pub. avail. July 25, 1990); *Department of Labor (Charles Lerner)*, SEC No-Action Letter (pub. avail. Oct. 25, 1988).

<sup>9</sup> *Department of Labor (Charles Lerner)*, SEC No-Action Letter (pub. avail. Oct. 25, 1988).

practices. We submit that, as it has in the past, the DOL should take advantage of the SEC's fact-finding activities and permit the SEC to take the lead regarding new soft dollar requirements. The DOL should be confident in the SEC's determination, after such careful study, whether current disclosure and other requirements are sufficient to protect *all* investors, including employee pension plans and other ERISA accounts, and, if not, what new regulations will provide such protection. Investment advisers are fiduciaries with respect to *all* of their clients, not just ERISA clients. The SEC will proceed from that fiduciary perspective in formulating soft dollar regulations.

The ICAA does not oppose, and indeed supports, reasonable disclosure requirements regarding soft dollar practices. Our members recognize that brokerage is a client asset and that, when using client brokerage for research, an adviser must comply with the fiduciary duty it owes its clients. We would object, however, to the potential imposition of two *differing* sets of rules and regulations regarding soft dollar practices – one by the SEC and the other by the DOL. There is no reason that an investment adviser's disclosures about soft dollar arrangements to ERISA clients should be materially different from such disclosures to other institutional and retail clients. Indeed, we are not aware that any evidence has been presented of a pattern of serious abuses regarding soft dollar usage in the pension area. Thus, while fully recognizing the DOL's authority to administer ERISA, we can perceive no need for special ERISA disclosure rules, over and above SEC regulation of these practices. The industry will be better able to comply with detailed rules and regulations established by one regulator that can serve as the ultimate decision-maker in this area.

Accordingly, should the Working Group determine that additional disclosures of soft dollar practices, or other requirements, are desirable, we propose that the Working Group recommend that DOL provide such input to the SEC for use in the SEC's deliberations regarding soft dollar regulation.

We appreciate your consideration of these comments. Please contact David Tittsworth, ICAA Executive Director, or Karen L. Barr, ICAA General Counsel, with any questions about this matter.

November 20, 1997

Mr. Neal E. Sullivan  
Executive Director  
North American Securities Administrators  
Association, Inc.  
10 G Street, N.E., Suite 710  
Washington, D.C. 20002

Re: Implementation of the Investment Advisers Supervision Coordination Act

Dear Neal:

I am writing to discuss how the various states are implementing the Investment Adviser Supervision Coordination Act (Coordination Act). As you know, the ICAA is a national not-for-profit association that exclusively represents SEC-registered investment adviser firms. Founded in 1937, our membership consists of more than 220 investment advisory firms that collectively manage funds in excess of \$1.3 trillion for a wide variety of institutional and individual clients. Since promulgation of the SEC's implementing regulations in May, we have been actively monitoring state developments in order to apprise our membership of applicable rules and regulations. While the situation continues to change almost daily, we wish to compare information with your organization about relevant trends in implementation of the new law.

Based on information available to date, we are pleased to report that a majority of states appear to be complying with both the spirit and the letter of the Coordination Act. In addition, state officials with whom we have communicated have been cooperative in providing information and discussing our comments on new state legislation and regulations. We also truly appreciate NASAA's efforts in working with us, as well as with its members, in achieving appropriate implementation of the new law.

However, we have serious concerns that the actions of a minority of states may threaten these positive efforts. Specifically, we are concerned that legislation, rules or guidelines in certain states: (1) require filings of documents and other materials that are not required to be filed with the SEC; (2) require filings and/or fees by investment adviser representatives with no place of business in the state; and (3) impose an additional layer of regulation on federally registered investment adviser firms and their supervised persons.

The primary purpose of the Coordination Act was to eliminate overlapping and duplicative regulation by allocating regulatory responsibility for larger investment advisers to the SEC and responsibility for smaller advisers to the states. Congress

accomplished this goal by preempting “all regulatory requirements imposed by state law on Commission-registered advisers relating to their advisory activities or services,”<sup>1</sup> subject to four limited exceptions: (1) states may require SEC-registered advisers to notice file; (2) states may require SEC-registered advisers to pay filing fees; (3) states may investigate and bring enforcement actions for fraud or deceit against SEC-registered investment advisers; and (4) states may license, register, or otherwise qualify investment adviser representatives who have a place of business located in that state. None of the rules promulgated by the several states at issue here fit into any of these exceptions.

*Notice Filing Requirements for Investment Advisory Firms.* Several state securities divisions have issued regulations or guidelines that require federally registered investment advisers to file various forms, rosters, letters, and other documents that are not required to be filed with the SEC.<sup>2</sup>

Section 307(a) of the Coordination Act provides: “Nothing in this title or any amendment made by this title prohibits the securities commission . . . of any state from requiring the filing of *any documents filed with the Commission* pursuant to the securities laws solely for notice purposes, together with a consent to service of process and any required fee.” (emphasis added). In conformity with the Coordination Act’s theme of efficient, uniform regulation, the concept of notice filing is that firms should provide states with *copies* of documents as *notice* of what they have filed with the SEC. But state filing requirements that go beyond SEC-filed documents are not permitted by the Coordination Act.<sup>3</sup> Moreover, some of these guidelines and rules directly conflict with many state laws which typically authorize securities commissioners to require notice filings that only consist of documents filed with the SEC.

*Notice Filing and Fee Requirements for Investment Adviser Representatives.* At least three state securities departments have issued regulations or guidelines that purport to require notice filings and/or fees from investment adviser representatives that do *not* have a *place of business* in the state, but are merely *doing business* there.<sup>4</sup> We

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<sup>1</sup> Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 99 at 28125 (May 22, 1997).

<sup>2</sup> Examples of these states include Idaho, Kentucky, Minnesota, Missouri, North Carolina (proposed), Pennsylvania, Rhode Island, and Texas. Please note that examples used in this letter are based on the best information we have to date. We would welcome the opportunity to discuss whether our information is inaccurate in any regard.

<sup>3</sup> We understand that NASAA is drafting a voluntary uniform notice filing form for SEC-registered advisers to submit with their notice filings. We have not had an opportunity to review the proposed form and therefore take no position on it at this time. We also note that at least one state has informed us it likely will modify NASAA’s proposed form for its own use. Such actions defeat the purpose of a uniform form and also are inconsistent with ongoing efforts to establish a one-stop filing system.

<sup>4</sup> Hawaii, Oklahoma, and Texas impose both filing and fee requirements on investment adviser representatives of federally registered firms, who have no place of business in the state. The Texas fees for representatives doing business in Texas are particularly onerous, given that the fee per representative is more than double that charged in the next highest state.

understand that other states are considering similar rules. These developments are of primary concern to our member firms.

The Coordination Act permits a state only to license, register, or qualify investment adviser representatives who have a place of business in that state.<sup>5</sup> Congress enacted this compromise specifically to address states' concerns about monitoring representatives operating out of local branch offices. The Coordination Act does not allow states to impose any requirements on investment adviser representatives who are merely doing business in the state. The notice filing provision of the Coordination Act permits states to require the filing of only those documents filed with the SEC. Because investment adviser representatives have no SEC filing obligations, they cannot be required to file anything with the states.

Similarly, the Coordination Act does not permit states to require investment adviser representatives with no place of business in a state to pay fees. The Coordination Act does not authorize states to collect *any* type of fee. Rather, the Act only permits states to collect "filing, registration, or licensing fees."<sup>6</sup> As discussed above, investment adviser representatives with no place of business in a state cannot be required to submit any filings, for notice purposes or otherwise. Nor are they subject to any registration or licensing requirements. Thus, the Act does not leave room for states to charge a "doing business" fee on these individuals.<sup>7</sup>

Further, this purported "doing business" requirement imposes a heavy burden on large advisers to monitor the movements of hundreds of employees and to analyze each state's interpretation of the phrase "doing business."<sup>8</sup> This burden of analyzing the varying state laws was precisely what Congress intended to eliminate in enacting the

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In addition, Alabama and Massachusetts require filings regarding investment adviser representatives who are doing business, but do not have a place of business, in the state (a roster in Alabama and Schedule Ds in Massachusetts). We understand that Hawaii goes much further in requiring investment adviser representatives *doing business* in Hawaii to file the same registration forms as representatives with a place of business in Hawaii, while stating that the forms are for "informational" purposes.

<sup>5</sup> Section 203A(b)(1)(A) of the Coordination Act.

<sup>6</sup> Section 307(b) of the Coordination Act.

<sup>7</sup> Some state officials have indicated to us that they charge these fees because they believe that the Coordination Act was intended to be revenue neutral. The states' desire not to lose revenue, however understandable, cannot supplant the plain language and meaning of the Act. Section 307 of the Coordination Act simply clarifies that states can continue to assess fees on investment advisers. It does not constitute a license to impose fees that are unreasonable or unrelated to the scope and purpose of regulatory functions they support.

<sup>8</sup> Indeed, Texas is contemplating requiring firms to submit paperwork and fees on a quarterly or semi-annual basis, rather than once a year, for representatives who do business in the state for the first time during that quarter or six months' period.

Coordination Act. The “doing business” requirement undermines the Coordination Act’s goal of reducing overlapping regulatory burdens through “regulatory clarity, certainty and uniformity.”<sup>9</sup>

*Second Layer of Substantive Regulations.* A few states have enacted or proposed provisions that impose a second layer of substantive regulation on SEC-regulated investment advisers.<sup>10</sup> Examples include regulations regarding custody, performance fees, and agency cross transactions. At least one state asserts that such regulations fall within its limited authority to bring enforcement actions for “fraud or deceit.”

The purpose of the Coordination Act was to eliminate overlapping and duplicative regulation of large advisers by the Commission and the states by *dividing* regulatory responsibilities. The plain language of the Coordination Act and accompanying legislative history unequivocally prohibit states from imposing a second layer of regulation on SEC-registered advisers. Thus, for example, Senators Gramm and Dodd have stated that Congress intended the Act to “preempt not only a state’s specific registration, licensing or qualification requirements, but *all regulatory requirements imposed by state law* on investment advisers relating to their advisory activities or services, except for those activities specifically identified in the statute [*i.e.* fraud or deceit].”<sup>11</sup>

The SEC has explained that “state regulatory provisions, such as those that establish recordkeeping, disclosure, and capital requirements, will no longer apply to advisers registered with the Commission.”<sup>12</sup> The SEC also has correctly interpreted the Coordination Act to prohibit states from re-regulating SEC-registered advisers through the back door of defining “dishonest or unethical” business practices, except to the extent those practices would otherwise constitute actual fraud or deceit. If states are free to define “fraud or deceit” to include any and all manner of substantive regulation, the Coordination Act will be rendered meaningless. Indeed, in providing technical assistance

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<sup>9</sup> Letter dated April 25, 1997 to SEC Chairman Arthur Levitt from Phil Gramm (R-Tex) and Christopher J. Dodd (D-Conn), at p. 2.

<sup>10</sup> North Carolina and Tennessee have both adopted temporary or emergency regulations that impose substantive regulation on SEC-registered advisers. North Carolina’s rules involve custody, agency cross transactions, and performance fees, while Tennessee’s rules involve custody, financial and disciplinary disclosure, advertising, cash solicitation, and agency cross transactions. Neither state’s regulations have become permanent, although Tennessee’s will become final soon.

In addition, Delaware’s statute imposes custody and performance fee regulations on investment adviser representatives, including those employed by SEC-registered advisers. Because these types of requirements are normally obligations of a *firm* rather than its employees, these provisions may have the effect of regulating SEC-registered firms.

<sup>11</sup> Letter dated April 25, 1997 to SEC Chairman Arthur Levitt from Phil Gramm (R-Tex) and Christopher J. Dodd (D-Conn), at p. 1 (emphasis added).

<sup>12</sup> Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 99 at 28125 (May 22, 1997).

to Senate personnel drafting the Coordination Act, the SEC staff stated that the provision “limiting the [states’] authority to bringing enforcement actions [for fraud and deceit] precludes a state securities commission from re-regulating advisers by issuing anti-fraud rules.”<sup>13</sup>

### *Conclusions*

The Coordination Act’s purpose of dividing responsibility between the SEC and states is sensible and cost-effective. The SEC can now focus on larger advisers who operate in interstate commerce and states can concentrate on the many smaller advisers and financial planners. This allocation of responsibility should enhance investor protection and improve utilization of limited regulatory resources. The new law also should result in less duplicative and burdensome regulation.

The recent report from NASAA’s task force on state and federal regulation recognizes the importance of these goals.<sup>14</sup> For example, the report notes that over the last 20 years, “both state and federal securities laws evolved into a more complementary system of regulation with less duplication.”<sup>15</sup> It states that “designers of regulation should seek to reduce costs as much as possible through regulations and regulatory tools that are, to the extent possible, clear, simple, uniform and reasonable.”<sup>16</sup> The report also makes specific recommendations relating to investment adviser regulation, such as urging state securities regulators to “streamline procedures for registering investment advisers and investment adviser representatives” and to develop “a uniform set of standards and qualifications to be applied universally from jurisdiction to jurisdiction.”<sup>17</sup>

I would appreciate the benefit of your thoughts on the matters outlined in this letter and any suggestions you may have as to how appropriate implementation of the Coordination Act may be achieved. We are not particularly interested in re-opening the disagreements that developed when the Coordination Act was being debated. Rather, we would prefer to work with you and the individual states to achieve a constructive solution to these pressing issues.

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<sup>13</sup> Memorandum dated May 16, 1996 from the Division of Investment Management to the Senate Securities Committee Staff, File Docket No. F7-98 (emphasis added). Indeed, the Division of Investment Management had recommended including the provision permitting state enforcement actions for fraud and deceit because it believed that the Coordination Act would have preempted such authority unless specifically preserved. *Id.*

<sup>14</sup> *Report of the Task Force on the Future of Shared State and Federal Securities Regulation*, October 1997.

<sup>15</sup> *Id.*, p. xviii.

<sup>16</sup> *Id.*, p. 5. Another current obstacle to uniformity is presented by the five states (Georgia, Nebraska, New Hampshire, Texas, and Vermont) that do not have a *de minimis* exemption for notice filing. (Texas technically has a *de minimis* exemption, but because it is not self-executing, it presents the same uniformity issues as not having the exemption at all). In the interest of uniformity, we hope NASAA will encourage these states to adopt the same “five or fewer clients” *de minimis* standard adopted by the rest of the states.

<sup>17</sup> *Id.*, p. 28.

I look forward to discussing these issues with you and truly appreciate the work NASAA and the states have undertaken to ensure that the new law is administered fairly and uniformly. Please do not hesitate to contact me or Karen Barr, ICAA General Counsel, if we may provide additional information to you or your staff.

Sincerely,

David G. Tittsworth  
Executive Director

cc: The Honorable Arthur Levitt  
The Honorable Norman S. Johnson  
The Honorable Isaac C. Hunt, Jr.  
The Honorable Paul R. Carey  
The Honorable Laura Unger  
Barry P. Barbash, Director, Division of Investment Management  
Robert E. Plaze, Associate Director, Division of Investment Management

December 24, 1997

Mr. Barry P. Barbash, Director  
Division of Investment Management  
Ms. Lori A. Richards, Director  
Office of Compliance, Inspections and Examinations  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Dear Mr. Barbash and Ms. Richards:

We are writing to urge you to recommend in your report to the Commission on soft dollar practices that the SEC take the lead in administering a single set of uniform regulations for such practices throughout the investment advisory industry. The ICAA recognizes the important fiduciary issues raised by soft dollar practices and supports reasonable requirements regarding those practices. We seek here only uniformity of regulation.

The Investment Counsel Association of America (ICAA) is a national not-for-profit association that exclusively represents SEC-registered investment adviser firms. Founded in 1937, our membership consists of 225 investment advisory firms that collectively manage funds in excess of \$1.3 trillion for a wide variety of institutional and individual clients.

The ICAA is concerned with the proliferation of regulators and industry organizations that are studying soft dollar issues and considering changes to regulations and industry standards. For example, it is well known that the SEC staff is drafting a report to the Commission describing soft dollar practices in the securities industry, which is expected to be completed shortly. The report will be based primarily on information received during extensive fact-finding examinations of soft dollar practices of more than 300 brokers, consultants, and investment advisory firms. The report may include recommendations for changes in regulation or disclosure of these practices. We are also aware that the SEC's Task Force on Investment Adviser Regulation is in the process of revising Form ADV and may revise the section in that document requiring soft dollar disclosure.

Similarly, the ERISA Advisory Council's Working Group on Soft Dollar Arrangements and Commission Recapture held hearings this year regarding soft dollar issues and recently made recommendations in a report to the Secretary of Labor. Some of these recommendations, although aimed at plan sponsors, would have the effect of

requiring advisers to make certain new soft dollar disclosures. The Advisory Council did not have the opportunity to coordinate its recommendations with any recommendations that may be included in the SEC staff's soft dollar report.

Several industry groups also are examining soft dollar issues and contemplating various standards and actions. For example, the Association for Investment Management and Research (AIMR) has formed a blue ribbon committee to study soft dollar issues. The AIMR committee has developed recommendations for industry standards regarding soft dollar practices, subject to AIMR interpretations, similar in form to the AIMR performance presentation standards. The Investment Company Institute has drafted a position paper or "white paper" on the same subject. Finally, the Securities Industry Association has issued "best practices" guidelines for soft dollar and other commission arrangements, principally focusing on the duties of broker-dealers.

The DOL and industry associations are very important participants in the soft dollar discussion. However, because the SEC has performed the most extensive fact-finding research on soft dollar practices, has the exclusive authority to interpret Section 28(e) of the Securities Exchange Act of 1934, and is the industry's primary regulator, we respectfully suggest that the SEC take the lead in establishing and administering soft dollar regulations. We urge the staff to consult closely with the DOL and industry groups to ensure that there is *one* consistent standard for soft dollar practices throughout the industry and for *all* clients, whether or not they are pension funds or other ERISA clients.

The ICAA does not oppose, and indeed supports, reasonable disclosure requirements regarding soft dollar practices. Our members recognize that brokerage is a client asset and that, when using client brokerage for research, an adviser must comply with the fiduciary duty it owes its clients. We would object, however, to the potential imposition of several *differing* sets of standards regarding soft dollar practices administered by different groups – one by the SEC, one by the DOL, and one or more from industry organizations.<sup>1</sup> We can perceive no compelling rationale for competing standards. For example, there is no reason that an investment adviser's disclosures about soft dollar arrangements to ERISA clients should be materially different from such disclosures to other institutional and retail clients. On the contrary, the industry will be better able to comply with detailed rules and regulations established by one regulator that can serve as the ultimate decision-maker in this area.<sup>2</sup>

In a similar vein, we do not believe it is constructive for industry groups to set standards that, as a practical matter, impose additional layers of "regulation" on investment advisers. Interpretation of Section 28(e) and development of rules for use and disclosure of soft dollars is and should be the sole province of the SEC. Once the SEC

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<sup>1</sup> The ICAA also would object to multiple sets of regulations established by different agencies, even if they imposed the *same* standards. Standards that initially are identical may diverge over time, through amendments to regulations or guidelines or through differing interpretations issued by the regulators.

<sup>2</sup> Because the costs of complying with multiple sets of inconsistent regulations may be passed on to investors, uniformity of regulation is in the public interest. Investors benefit when their investment advisers can readily understand and comply with one clear set of regulations.

has promulgated such interpretations and rules, industry groups may then usefully issue voluntary guidelines for “best practices” within those rules. By not awaiting the SEC’s soft dollar report and recommendations, industry groups may be formulating soft dollar standards prematurely and in potential conflict with forthcoming SEC rules and interpretations.

Accordingly, we respectfully suggest that the SEC consult with all interested parties and take the lead in administering *one* set of regulations for soft dollar compliance for the investment management industry.

We appreciate your consideration of these comments. Please contact the undersigned or Karen L. Barr, ICAA General Counsel, with any questions about this matter.

Sincerely,

David Tittsworth  
Executive Director

Cc: The Honorable Alexis Herman  
U.S. Department of Labor

Mr. James O. Wood, Chairman  
Working Group on Soft Dollars/Commission Recapture

Mr. Thomas A. Bowman, President  
Association for Investment Management and Research

Mr. Matthew P. Fink, President  
Investment Company Institute

Mr. Mark E. Lackritz, President  
Securities Industry Association