ICAA

Investment Counsel Association of America

1998 ICAA Comments & Statements

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January 15, 1998

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Release IA-1682, File No. S7-29-97, Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account

Dear Mr. Katz:

The Investment Counsel Association of America ("ICAA") appreciates the opportunity to comment on the Securities and Exchange Commission's proposed amendments to Rule 205-3 under the Investment Advisers Act of 1940 ("Advisers Act"). The ICAA is a national not-for-profit association that exclusively represents federally 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. For the reasons discussed below, the ICAA strongly supports the Commission's Rule 205-3 proposal.

Background

Section 205(a)(1) of the Advisers Act prohibits an investment adviser from entering into contracts with clients that provide for fees to the adviser based on a share of capital gains on, or capital appreciation of, client funds. This prohibition is based on the concern that performance fees might provide advisers an incentive to take undue risks with their clients' portfolios in order to increase fees.[1] Congress and the Commission nevertheless have recognized that advisers should be permitted to enter into performance

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1 *See* Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Release No. 1682, File No. S7-29-97, 62 Fed. Reg. 61882 (November 19, 1997) ("Proposing Release").

This concern also prompted the ICAA initially to ban performance fees in its Standards of Practice. After Rule 205-3 was adopted in 1985, the ICAA revised its Standards to permit performance fees in light of the new rule, industry practice, and the fact that institutional clients were increasingly requesting such arrangements to ensure that advisory fees provided "value added" benefits rather than simply being a function of upward trends in prices. At the same time, the ICAA cautioned its members regarding the potential pitfalls of such fees.

fee arrangements, subject to various restrictions, with certain types of clients who adequately are able to protect themselves from this risk.[2]

Rule 205-3 under the Advisers Act permits an adviser to charge performance fees to a client that has $500,000 under management with the adviser or a net worth of $1 million (*i.e.* a "qualified client"), subject to numerous contractual and disclosure requirements. The SEC has noted that "[b]ecause of their wealth, financial knowledge, and experience, the Commission presumed that these clients are less dependent on the protections provided by the Advisers Act's restrictions on performance fee arrangements."[3]

I. Elimination of Specific Contractual and Disclosure Requirements.

The ICAA supports the Commission's proposal to eliminate the specific contractual and disclosure requirements currently imposed on performance fee arrangements with qualified clients. These requirements include: (a) prescribed methods of calculation of the fee; (b) that the fee be calculated with respect to performance for a period of not less than one year; (c) several specific mandated disclosures to clients; and (d) that the adviser reasonably believes that the contract is an arms-length arrangement and that the client understands the arrangement and its risks.

These Rule 205-3 obligations, particularly the calculation and one-year-period requirements, have hindered flexibility in creating performance fee arrangements that could benefit both advisers and their clients. Performance fee arrangements appear to be increasingly client-driven. Institutional and high net worth clients often approach advisers with creative proposals for performance fee incentives that they feel more properly apportion risks of poor performance and benefits of good performance than traditional fee arrangements. Such arrangements also may be more cost effective for these clients. These sophisticated clients should be able to negotiate the terms of such contracts as they see fit. Thus, we agree with the Commission's conclusion that "if a client appreciates the risk of performance fees and is in a position to protect itself from overreaching by the adviser, then the terms of the arrangements are best left to the client."[4]

The specific Rule 205-3 requirements also have posed difficult interpretive issues over the years, creating uncertainty and legal costs for advisers.[5] Elimination of detailed conditions and disclosures may reduce advisers' costs of compliance with Rule 205-3, as well as the burden on the Commission staff to respond to interpretive requests. Proposed

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2 For example, Section 205(b) of the Advisers Act permits an adviser to enter into performance fee contracts using fulcrum fees with investment companies, business development companies, and certain client accounts over $1 million.

3 Proposing Release, 62 Fed. Reg. at 61883.

4 *Id.* at 61883-61884.

5 *Id.* at 61886.

Rule 205-3 is significantly more simple and easy to understand than the current rule and therefore comports with the Commission's recent statements on the use of "plain English."

Elimination of Rule 205-3's specific requirements would not leave sophisticated investors unprotected from malfeasance by advisers. Advisers charging performance fees must still act in accordance with their fiduciary duties to their clients and will continue to be subject to the Commission's anti-fraud prohibitions. Further, under fiduciary and anti-fraud principles, advisers will still be obligated to disclose to clients all material information about the performance fee arrangements.

II. Qualified Clients and Transition Rule.

The SEC proposes to change the high net worth criteria for sophisticated clients (proposed to be called "qualified clients") to reflect the effects of inflation since the standards were adopted. The threshold levels would be increased from $500,000 under management with the adviser or a $1,000,000 net worth to $750,000 and $1,500,000 respectively. The Commission also proposes to include "qualified purchasers" under section 2(a)(51)(A) of the Investment Company Act as "qualified clients" under Rule 205-3. The ICAA supports these proposals.

The proposed Rule 205-3 amendments are intended to permit advisers to charge performance fees to clients who are sufficiently wealthy and sophisticated to negotiate the terms of their own contracts without the restrictions imposed by current Rule 205-3. Because of inflation and the effects of a prolonged upward trend in the stock market, persons with $500,000 under management with an adviser or a $1 million net worth may not be as sophisticated, relatively, as they were when Rule 205-3 was initially issued. The Commission's proposal will ensure that unsophisticated retail clients continue to receive the protections of the performance fee prohibition. At the same time, we believe that automatic indexing of the "qualified client" criteria[6] would be more complicated and difficult to monitor than the absolute numbers currently proposed. Instead, the Commission should retain the flexibility to reassess the "qualified client" criteria periodically and adjust them as necessary in light of inflation, market conditions, and other relevant factors.

The ICAA also supports the transition rule grandfathering current performance fee arrangements. Such a rule is necessary to avoid interference with current client relationships. Current clients with between $500,000 and $750,000 under management or having between a $1 million and $1.5 million net worth will continue to receive any protections provided by the specific conditions and disclosure requirements of Rule 205-3 that were in effect when their performance fee contracts were executed.

[6] *See* Proposing Release, 62 Fed. Reg. at 61885 (requesting comment on whether such criteria should be indexed).

The Commission's proposed inclusion of "qualified purchasers" as "qualified clients" similarly is reasonable. Clients with at least $5 million in investments should be presumed to be as sophisticated and financially experienced as clients with $750,000 under management or a $1.5 million net worth.[7]

III. Identification of the Client.

The ICAA supports the Commission's proposal to retain the "look-through" provision of Rule 205-3. This provision prevents advisers from organizing pools of unsophisticated investors into a private investment company for the purpose of evading the performance fee prohibitions of the Advisers Act. Such a provision is necessary for the protection of unsophisticated investors.

IV. Recommendation for Future Study

We suggest that the Commission consider studying whether to better rationalize the entire scheme of "sophisticated client" criteria.[8] For example, advisers and other market participants must have a multitude of compliance procedures and guidelines in place to determine who is (1) a "qualified client" under Rule 205-3; (2) a "qualified purchaser" under Section 3(c)(7) of the Investment Company Act; (3) an "accredited investor" under Regulation D of the Securities Act of 1933; and (4) a "qualified institutional buyer" under Rule 144A of the Securities Act of 1933.[9] These varying definitions have a similar goal: preventing certain practices as applied to unsophisticated clients. More consistency among these rules may be beneficial for both advisers and investors, providing ease of compliance and interpretation.[10]

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7 Indeed, this type of rationalization of various high net worth criteria is the subject of our recommendation in Section IV below.

8 We do not intend to suggest that the Commission delay the current proposal to study this issue; the current proposal merits prompt action. Rather, the Commission's proposal highlights the need to begin consideration of whether it is feasible to achieve more consistency among the various rules and statutes defining high net worth individuals.

9 In addition, many advisers must consider whether their clients are "qualified eligible clients" or "qualified eligible participants" pursuant to Rule 4.7 under the Commodity Exchange Act. We therefore urge the Commission to coordinate with the CFTC regarding rationalization of these varying criteria.

10 Accordingly, we applaud the Commission's consistency in using the same "qualified client" definition in both Rule 205-3 and Rule 203A-3 (regarding "investment adviser representatives").

Please do not hesitate to contact the undersigned or David G. Tittsworth, Executive Director, at (202) 293-4222 with any questions or requests for information.

Sincerely,

THE INVESTMENT COUNSEL ASSOCIATION
OF AMERICA, INC.

By:

KAREN L. BARR
General Counsel

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

January 15, 1998

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Release IA-1681, File No. S7-28-97, Exemption for Investment Advisers Operating in Multiple States; Revisions to Rules Implementing Amendments to the Investment Advisers Act of 1940

Dear Mr. Katz:

The Investment Counsel Association of America ("ICAA") appreciates the opportunity to comment on the Securities and Exchange Commission's proposed amendments to refine the rules implementing the Investment Advisers Supervision Coordination Act ("Coordination Act"). The 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 Commission has proposed two principal amendments to the rules implementing the Coordination Act, as well as certain technical amendments. One of the principal amendments would permit advisers that are required to register in 30 or more states to register with the SEC even if they do not have $25 million or more of assets under management or meet any other current exemption from the prohibition on SEC registration. The ICAA takes no position on this proposed amendment.

The other principal amendment would revise the definition of "investment adviser representative" to permit managers who have only a few large institutional or business clients to continue to service accommodation clients without being subject to state registration and qualification requirements. The SEC has proposed two alternative amendments to the "investment adviser representative" definition to address this problem: (1) retain the current "ten percent allowance" test, but add a bright-line standard that would permit supervised persons to have five natural person clients; or (2) eliminate the "ten percent allowance" test and permit supervised persons to have an unlimited number of natural person clients with a high net worth or who are related either to adviser personnel or to institutional clients. The SEC also proposes to change the criteria for determining "high net worth" clients, applicable to both alternative proposals.

For the reasons discussed below, the ICAA supports the Commission's first alternative amendment to the definition of "investment adviser representative." The ICAA also supports the Commission's proposed revision to the "high net worth" criteria.

I. The ICAA Supports the "Number of Clients" Test.

The Coordination Act generally preempts state regulation of SEC-registered investment advisers and their supervised persons, but permits a state to register, license or qualify an investment adviser representative who has a place of business located within that state.[1] Rule 203A-3(a) currently defines "investment adviser representative" as a supervised person more than ten percent of whose clients are natural persons, other than high net worth individuals.[2] This definition permits supervised persons who principally advise business or institutional clients to continue to advise a limited number of accommodation clients without being subject to state licensing or qualification requirements. In adopting this definition, however, the Commission expressed concern that a "representative who works on one or a few institutional or business client accounts may not be able to accept any accommodation clients because, if she did, more than 10 percent of her clients would consist of natural persons."[3]

The SEC has proposed two alternatives to resolve this issue. The first alternative would retain the ten percent allowance and add a provision permitting supervised persons to have up to five natural person clients (other than high net worth individuals) without being deemed to be an investment adviser representative ("number of clients test"). Thus, supervised persons could have the greater of five natural person clients or the number of natural person clients calculated under the ten percent allowance without being subject to state registration and qualification requirements.

The second alternative would eliminate the ten percent allowance standard and instead permit supervised persons to have an unlimited number of natural person clients of the following types: (a) high net worth clients; (b) partners, officers or directors of the adviser or of business or institutional clients of the adviser; (c) relatives, spouses or relatives of spouses of such partners, officers or directors; or (d) relatives, spouses or relatives of spouses of the supervised person ("relationships test").

Both alternatives would accomplish the Commission's goal of permitting supervised persons with one or a few institutional clients to accept some accommodation clients without being subject to state registration or qualification requirements. In our view, however, the first alternative is significantly preferable to the second alternative. The number of clients test is bright-line, simple, and straightforward. Since the current definition of "investment adviser representative" became effective on July 8, 1997, SEC-

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1 Section 203A(b) of the Coordination Act.

2 17 CFR 275.203A-3(a).

3 Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997), 62 Fed. Reg. 28112 at 28122 (May 22, 1997) ("Adopting Release").

registered investment advisers have already gone through the process of counting their employees' natural person clients and determining which employees are investment adviser representatives. Based on feedback we have received from our members, it appears that this process was fairly time-consuming, but not overly complicated. Now that states and advisers have spent significant time implementing the current definition in workable fashion, the Commission should not abandon this test for a wholly different standard.[4] By the same token, advisers would be able to incorporate another similar counting test (the five-client standard) relatively easily into their current procedures for counting the ten percent allowance.

An adviser can more readily count its employees' clients than determine and monitor the relationships between the accommodation clients and their related families and businesses.[5] For example, under the relationships test, an adviser would have to monitor whether clients are getting separated or divorced from persons employed by the adviser or the adviser's business or institutional clients. Once divorced, presumably those clients and relatives of those clients would no longer fall within the relationship test.[6] Similarly, an adviser would have to monitor the employment situation of all accommodation clients. As natural person clients change employment, they may cease to have a relationship with business or institutional clients of the adviser. This monitoring of relationships and employment would have to be constant, given that these tests are measured in terms of current clients rather than over a twelve-month or other period.[7] In addition, determining which employees of an institutional client are "officers" or "other person[s] occupying a similar status or performing similar functions" is not always straightforward.

Accordingly, the ICAA supports the simple bright-line "number of clients" test proposed by the Commission as the first alternative.

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4 For this reason, we would be more receptive to the relationships test if it were implemented *in addition to*, rather than instead of, the ten percent allowance test.

5 In addition, the relationships test, as currently proposed, may be too rigid. Under the proposed test, for example, a supervised person who advises only large institutional clients would not be able to accept even one unrelated close friend as an accommodation client without being subject to state qualification requirements. Such a result is not rational.

6 Advisers already have to conduct this type of monitoring to some extent because the definition of "client" in Rule 203(b)(3)-1 requires knowledge of which relatives of the client occupy the same principal residence.

7 *See* Adopting Release, 62 Fed. Reg. at 28122.

II. The ICAA Supports the Proposed "High Net Worth" Amendment.

Under the current definition of "investment adviser representative," individuals with a "high net worth" are not counted toward the ten percent allowance. In defining high net worth clients, the Commission used the same criteria used in Rule 205-3 under the Advisers Act to determine which clients were permitted to enter into performance fee contracts with investment advisers. The SEC noted that "[b]ecause of their wealth, financial knowledge, and experience, the Commission has presumed that these individuals are less dependent on the protections of the provisions of the Advisers Act that prohibit such fee arrangements. The Commission believes that such individuals similarly do not need the protections of state qualification requirements."[8]

As part of several proposed amendments to Rule 205-3, the SEC proposes to change the high net worth criteria to reflect the effects of inflation since the standards were adopted. The threshold levels would be increased from $500,000 under management with the adviser or a $1,000,000 net worth to $750,000 and $1,500,000 respectively. The ICAA supports the Commission's concurrent proposal to explicitly tie the "high net worth" standard in the "investment adviser representative" definition to the Rule 205-3 standard, including the proposed increase in threshold levels.[9] Investment advisers and regulators both benefit greatly from uniformity among the various standards and definitions in the Investment Advisers Act of 1940. Explicitly incorporating the Rule 205-3 standard also ensures consistency in interpretation and application of the standard, while eliminating the need to further amend the "investment adviser representative" definition should the Rule 205-3 criteria for high net worth clients be revised again in the future.

In connection with increasing the threshold levels for determining which clients are counted toward the ten percent allowance, we suggest that the Commission adopt a transition or grace period for investment adviser representatives. Without a grace period, advisory personnel relying on the current thresholds may immediately be deemed in violation of state registration or qualification requirements on the date that the rule amendment becomes final. Accordingly, we suggest adding a provision stating that the amendment to Rule 203A-3(a) will become effective 120 days after the date the final rule is published in the Federal Register. This will provide supervised persons the opportunity to determine whether they are "investment adviser representatives" under the new test, and, if so, where and how they must register, as well as to take any examination required by the state prior to registration.

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8 *Id.*

9 The current "investment adviser representative" definition simply repeats the current Rule 205-3 high net worth language, rather than incorporating Rule 205-3 by reference as the Commission now proposes.

Please do not hesitate to contact the undersigned or David G. Tittsworth, Executive Director, at (202) 293-4222 with any questions or requests for information.

Sincerely,

THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.

By:

KAREN L. BARR
General Counsel

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

February 26, 1998

Mr. Thomas A. Bowman
President and Chief Executive Officer
Association for Investment Management
and Research
5 Boar's Head Lane
P.O. Box 3668
Charlottesville, VA 22903-0668

Re: AIMR Blue Ribbon Task Force for Soft Dollar Standards

Dear Tom:

The Investment Counsel Association of America (ICAA) appreciates the opportunity to comment on the Report of the AIMR Blue Ribbon Task Force for Soft Dollar Standards.[1] We applaud AIMR's efforts to raise and address difficult issues related to soft dollar usage. AIMR's goal of providing guidance to advisers and investors in this important area is commendable. The ICAA shares AIMR's objective of supporting higher ethical standards for the investment advisory industry. We believe, however, that the interests of advisers and investors would best be served by a single uniform set of standards administered by the SEC. Accordingly, we urge the AIMR Board to refrain from adopting the Task Force's recommendations at this time.

As you know, 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 well include recommendations for changes in regulation or disclosure of these practices. The SEC's Task Force on Investment Adviser Regulation is in the process of revising Form ADV and is likely to revise the section in that document requiring soft dollar disclosure.

In addition, the ERISA Advisory Council's Working Group on Soft Dollar Arrangements and Commission Recapture held hearings this year regarding soft dollar

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[1] 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 $1.5 trillion for a wide variety of institutional and individual clients. The ICAA's member firms employ numerous CFAs who are AIMR members.

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 ICAA is concerned that the SEC, DOL, and AIMR are considering differing standards regarding soft dollar practices. We believe there should be *one* consistent standard for soft dollar practices for *all* advisers, whether or not they employ AIMR members, and for *all* clients, whether or not they are pension funds or other ERISA clients. 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, the SEC should take the lead in establishing and administering a single set of uniform regulations for soft dollar practices applicable throughout the entire investment advisory industry. As you know, we recently wrote the SEC staff urging that course of action.

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. However, we do not believe it is constructive for industry groups such as AIMR to set standards that, as a practical matter, impose additional layers of "regulation" on investment advisers.[2] 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 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, AIMR's proposed soft dollar standards are premature and in potential conflict with forthcoming SEC rules and interpretations.

Further, the AIMR Task Force's proposals depart from current law and practice in several respects. As a result, the proposals will cause more confusion than clarity in the industry. If, as is likely, some firms adopt the AIMR recommendations and others do not, advisers and investors will be speaking two languages with different definitions for the same terminology. Examples of confusion that will result from differing standards include:

1. *Definition of "Brokerage."* The Task Force definition includes principal trades, in addition to agency trades, in the definition of brokerage, and therefore soft dollar arrangements. Under the SEC's interpretation, however, Section 28(e)'s safe harbor does not extend to principal transactions.

[2] The Task Force Report is unclear as to whether all CFAs will be required to conform to the proposed AIMR soft dollar standards in order to retain their CFA designation. To the extent that such compliance is required, AIMR would in effect be regulating advisory firms through the back door of imposing requirements on firm employees. In addition, as with the AIMR-PPS (performance presentation standards), some firms may feel obligated to follow the AIMR soft dollar standards based on consultant requests, while others are not so moved, creating inconsistent industry practices.

2. *Definition of "Research."* The Task Force defines research to require the primary content of the soft dollar product or service, if used by the investment manager, to directly assist the manager in its investment decision-making process and not in the management of the investment firm. The SEC definition analyzes whether the research provides lawful and appropriate assistance to the investment manager in the investment decision-making process.
3. *Definition of "Best Execution."* The Task Force definition focuses on "total cost," which may inaccurately lead to a focus solely on price. The SEC, however, has more fully explained that "the full range and quality of a broker's services" should be considered in the best execution calculus, and has warned that "the determinative factor is not the lowest commission cost but whether the transaction represents the best qualitative execution for the managed account."[3]

The SEC definitions in the soft dollar area have been developed over the course of many years and now are widely known and accepted. We are concerned that AIMR's adoption of different definitions may cause tremendous confusion and inconsistency in the industry. Investors and other industry participants will not readily be able to discern which definition is being used in various contexts and will not readily be able to process the different definitions used at various times. Moreover, the brokerage definition may be contrary to Section 28(e). Such a change in definition would require a change in the law, rather than a simple statement by a trade association.

The Task Force recommendations regarding disclosure and recordkeeping requirements also depart from current SEC requirements and would limit client flexibility.[4] Currently, advisers provide their clients with reports on soft dollar arrangements that are specifically tailored to client requests as to content and format. The Task Force's requirement of particular information to be provided clients would eliminate the client's ability to negotiate specific disclosures and burden the client with additional information the client may not desire. These types of problems played a role in the SEC's abandonment of its 1995 proposal regarding more specific soft dollar disclosure.

Accordingly, we urge the AIMR Board to decline to adopt the recommendations of the Task Force for Soft Dollar Standards, or at least to delay its decision until the SEC releases its soft dollar report and recommendations.

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[3] Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters. SEC Exchange Act Release No. 34-23170 (April 23, 1986).

[4] Further, AIMR proposes to prohibit allocating client brokerage based on the amount of client referrals the adviser receives from a broker. It is unclear whether this proposal is consistent with existing law or whether it prohibits this practice under any circumstances, including where all executions are otherwise equal and the adviser properly has disclosed the practice.

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 G. Tittsworth
Executive Director

cc: Mr. Barry P. Barbash, Director
Division of Investment Management

Ms. Lori A. Richards, Director
Office of Compliance, Inspections and Examinations

The Honorable Alexis Herman
U.S. Department of Labor

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

May 19, 1998

Pension & Welfare Benefits Administration
U.S. Department of Labor
Office of Exemption Determinations, Room N-5649
200 Constitution Avenue, N.W.
Washington, DC 20210
Attention: Cross-Trades of Securities

Re: Cross-Trades of Securities by Investment Managers

To Whom It May Concern:

These comments are being filed on behalf of the Investment Counsel Association of America (ICAA)[1] in response to the request by the Department of Labor (Department) in its Notice published March 20, 1998 (Notice)[2] for comments on a number of issues relating to the possible adoption of a class exemption from the prohibited transaction rules to permit cross-transactions involving accounts subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). We congratulate Department staff for recognizing the significance of these issues for ERISA-covered investors and appreciate the opportunity to express our views on the important topics referenced in the Notice.

When conducted with appropriate safeguards, the ICAA believes cross-trade transactions occurring between two managed accounts are clearly in the best interest of both clients because they reduce or eliminate unnecessary and often substantial transaction costs – particularly brokerage commissions on equity securities and dealer margins on debt instruments and other securities typically traded on a principal basis. In fact, it is precisely because of client demand that institutional investment managers have a strong interest in pursuing exemptive relief for these types of transactions.[3]

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[1] The ICAA is a national not-for-profit association that exclusively represents SEC-registered investment adviser firms. Founded in 1937, our membership consists of approximately 225 investment advisory firms that collectively manage funds in excess of $1.5 trillion for a wide variety of institutional and individual clients.

[2] 63 FR 13696.

[3] *See, e.g.,* "Losing the Middleman: Why the Methodist 403(b) plan insists on a manager with internal crossing capability." *Plan Sponsor*, March 1998.

Where permitted, institutional investors frequently request managers to conduct their securities trades on this basis. Because of their obvious advantages, cross-transactions are commonplace for non-ERISA-covered institutional investors. The Securities and Exchange Commission (SEC) has encouraged broker-dealers – many of whom manage accounts on a discretionary basis – to cross customer trades to achieve lower execution costs.[4] On the other hand, ERISA-covered pension plans, representing a major source of investment capital in the marketplace today, have been unable to avail themselves of the opportunity to participate in cross-trade transactions and to achieve the substantial transactional cost savings attendant thereto. As a result, pension plans are incurring costs and missing opportunities for increased incremental returns that otherwise would be available to provide well-funded and secure retirement benefits for America's workers. In effect, the cross-transaction prohibition is a constraint on the efficient deployment of a pension fund's capital.

Before responding to the questions identified in the Notice, following are general principles we believe the Department should follow in formulating exemptive relief for cross-transactions.

Direction of Exemptive Relief

As recognized in the Notice, the SEC and the Department currently impose very different requirements with respect to cross-transactions. In the case of cross-transactions involving a mutual fund, the trade must comply with provisions of SEC Rule 17a-7 under the Investment Company Act of 1940. In the case of cross-transactions involving employee benefit plans, an individual exemption must be obtained from the Department in order to be in compliance with ERISA.[5] Unfortunately, the conditions the Department has imposed in these exemptions and the

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[4] Order Handling Rules, Exchange Act Rel. No. 37619A (Sept. 6, 1996) at 198-220.

[5] The Department has stated that plan investment managers with discretion for both accounts cannot execute trades in this manner without raising issues under Section 406(b)(2) of ERISA. *See*, Reich v. Strong Capital Management, Inc., No. 96-C-0669, U.S.Dist.Ct. Eastern.District Wis. (June 6, 1996). While Prohibited Transaction Class Exemption (PTE) 86-128, 51 FR 41686 (Nov. 18, 1986), permits brokers that are affiliated with a fiduciary who has discretionary control over the plan's brokerage transactions to execute certain agency cross-transactions under certain circumstances, PTE 86-128 is not available where the broker (or its affiliate) has discretionary

conditions set forth in SEC Rule 17a-7 differ significantly from and are inconsistent with each other. In our view, the Department's constraints in this area occasion substantial and needless transactional costs on retirement plan clients and are contrary to the best interests of such clients.

The ICAA strongly believes the rules for investment advisers engaging in cross-trade transactions should be consistent regardless of the type of client involved. Consistent rules are appropriate because the Department and the SEC share the same underlying policy concerns regarding cross-transactions. Both the Department and the SEC seek to ensure that a fiduciary fulfills its duties to its clients by promoting cost savings and market efficiencies while at the same time ensuring that the interests of such clients are fully protected and served.

The ICAA believes Rule 17a-7 presents the most logical framework for developing a workable class exemption for cross-trade transactions, although we recognize that some modifications may be necessary to account for differences in the intended scope of the Department's and the SEC's protective mandates.[6] We believe there are fundamental elements of Rule 17a-7 that must be included in any exemptive relief considered by the Department in order to ensure the development of a consistent approach to this area. As discussed below, the most significant of these elements that should be adopted are the SEC's mechanism for pricing cross-trade transactions and obviating the Department's current transactional approval of each transaction.

Pricing Mechanism. The individual exemptions granted by the Department, which have been limited to securities for which there is a generally recognized market, have required the price of the stock to be set at the closing price on the day of trading.[7] Rule 17a-7, on the other

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authority over both accounts involved in the transaction.

[6] In this respect, the requirements of Rule 17a-7 are only applicable to transactions and entities regulated under the Investment Company Act and such requirements are not otherwise applicable to other entities – such as employee benefit plans. 17 CFR 270.17a-7.

[7] *See, e.g.,* Capital Guardian Trust Co., 89-104, 54 FR 53,397 (Dec. 28, 1989); Mercury Asset Management Int'l. Ltd., PTE 94-83, 60 FR 47,610 (Sept. 13, 1995).

hand, requires covered transactions to be effected at "current market price,"[8] which has as its fundamental principle the concept that the subject securities be priced on an independent basis.[9]

Accordingly, the means for determining "current market price" under Rule 17a-7 are intended to be completely beyond the control of the investment manager. While both Department and SEC rules presumably are intended to establish a pricing mechanism to ensure that managers cannot exercise discretion in pricing transactions for the benefit of either side of the transaction, Rule 17a-7 provides a pricing structure that is more reflective of the most recent market activity with respect to the subject security and also accommodates the broader range of securities found in the marketplace.

Transactional Approval. Individual exemptions granted by the Department in this area have been conditioned on obtaining advance or post-transaction confirmation.[10] This condition is inconsistent with Rule 17a-7 and also is problematic in that plan officials who hire investment managers to manage plan assets do not want to be involved in day-to-day investment decisions.

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[8] In the case of "reported securities," "current market price" is defined as the last sale price reported in the consolidated transaction reporting system, or, if no transactions have been reported on that day, the average of the highest current independent bid and lowest current independent offer for such security. For securities traded primarily on an exchange that are not reported securities, the "current market price" is the average of the highest current independent bid and lowest current independent offer on such exchange if there are no reported transactions on such exchange that day. In the case of securities that are not reported securities and are not traded principally on an exchange but are quoted in the NASDAQ system, "current market price" is the average of the highest current independent bid and lowest current independent offer reported on Level 1 of NASDAQ. Finally, "current market price" for all other securities is the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry. 17 CFR 270.17a-7(b)(1)-(4).

[9] The background of Section 17(a) and Rule 17a-7 and the rationale behind the current version of Rule 17a-7 are discussed thoroughly in Investment Company Act Release No. 11136 (April 21, 1980) [45 FR 29067, May 1, 1980] (Release No. 11136).

[10] *See*, exemptions cited, supra at n. 7.

Plan officials also are concerned that providing transactional approval may negate the fiduciary authority and responsibility assumed by the investment manager in connection with the transaction. Finally, opportunities for cross-trades do not arise in a consistent or contemplative manner. Rather, they present themselves as a result of investment decisions totally removed from the cross-trade. Under such circumstances, the cross-trade opportunity (which is a secondary product of the investment decision) is likely to be lost during the time it takes to seek client approval because of the need to go forward with the investment decision that led to the potential cross-trade in the first place.

Rather than imposing a transactional approval mechanism, Rule 17a-7 requires the board of directors of the investment company to adopt procedures designed to ensure compliance with conditions of the rule and to review the transactions quarterly to ensure that all such purchases or sales made during the preceding quarter were effected in compliance with these procedures. Similarly, a sophisticated plan sponsor or a qualified independent fiduciary is in a position to determine whether investment managers relying on an exemption are in compliance with the exemption's requirements without the imposition of the requirement that they provide transactional approval for each cross-trade transaction.

While acknowledging that Rule 17a-7 is effective in ensuring a fair and objectively determined price for a security, the Department indicates in the Notice that it "is not convinced that reliance upon an objective fair price alone will ameliorate the conflicts [identified in the Notice], such as the potential for 'cherry picking' or 'dumping' of securities or allocating investment opportunities among client accounts in a manner designed to favor one account over the other." 63 FR 13696, 13699. It is significant that these are the very same abuses cited by the SEC as the rationale for *adopting* the current version of Rule 17a-7.[11] It also is significant that Rule 17a-7 – which requires the cross-transaction to be effected at "current market price" – is intended to price the securities independently by taking into account the most recent market

[11] In adopting the current version of Rule 17a-7, the SEC noted that the rule was needed to avoid "serious harm to registered investment compan[ies]. For example, an unscrupulous investment adviser might 'dump' undesirable securities on a registered investment company or transfer desirable securities from a registered investment company to another favored advisory client in the complex." Release No. 11136.

activity with respect to the subject security and provides no "safe harbor" for the abuses described by the Department in its Notice.[12]

The Department's concerns appear to ignore the well-developed and comprehensive body of state and federal securities law that imposes fiduciary duties on investment managers acting on behalf of client accounts. The courts and the SEC agree that investment advisers are fiduciaries and owe certain statutory fiduciary duties to their clients. *See*, Arlen W. Hughes, 27 S.E.C. 629 (1948); Securities and Exchange Commission vs. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963). As a fiduciary, an investment adviser has an affirmative duty of utmost good faith to act solely in the best interests of the client. Consistent with ERISA's fiduciary rules, an investment adviser must always act in its clients' best interests and its conduct is measured against a higher standard of conduct than that applied in commercial transactions generally. *See,* Capital Gains, 375 U.S. at 188,195. In addition to general concepts of fiduciary duty, section 206 of the Investment Advisers Act of 1940 (Advisers Act) generally prohibits an investment adviser

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[12] The ICAA is somewhat perplexed at the Department's suggestion that cross trading would promote activities such as "dumping," "cherry-picking," and "front-running." In this regard, a manager required to comply with the pricing constraints of Rule 17a-7 conceivably would have an incentive to "dump" unwanted securities into another managed account or "cherry-pick" wanted securities from another managed account pursuant to a cross-trade only if the manager believed that the transaction would somehow reduce adverse market impact on the price of the securities in favor of the selling or purchasing account. Otherwise, there would be no reason not to simply sell or buy the securities on the open market. In fact, a theoretical desire to limit market impact could only be relevant to a small minority of trades involving highly illiquid or large blocks of securities and, as described in detail below, a cross-trade may be the fairest method for making the trade in such situations. A manager who truly desired to benefit one client over another would better serve such an illegal and disreputable purpose by engaging in "front-running," *i.e.,* placing one side of the trade into the market ahead of another managed account in order to profit from the market impact costs through the subsequent transaction. For example, a large buy order for illiquid securities would presumably drive the price up and a large purchase order would presumably drive the price down. Accordingly, the ICAA believes that "front-running" is a much more problematic activity in this context than "dumping" or "cherry-picking" and, significantly, the ability to cross-trade would serve to hinder "front-running" rather than promote such activity.

from employing any "device, scheme or artifice" to defraud clients or engaging in a "transaction, practice or course of business" that operates as a "fraud or deceit" on clients. It is not surprising then that many activities identified by the Department as causing it trepidation in proposing exemptive relief for cross-trade transactions have been found to violate section 206. *See, e.g.,* Capital Gains (trading ahead of client accounts, otherwise known as "front-running"); In re Account Mgmt. Corp., et al., Investment Advisers Act Release No. 1529 (September 29, 1995); In re John Giura, et al., Investment Advisers Act Release No. 1095 (Nov. 13, 1987) (favoring certain clients or proprietary accounts). The SEC also has sanctioned investment advisers for trade allocations that unfairly favor proprietary accounts of the adviser or its related persons over those of its clients. *See, e.g.*, In re Michael L. Smirlock, Investment Adviser Act Release No. 1387 (Oct. 20, 1993). Of course, to the extent cross-trades are engaged in on behalf of ERISA-covered accounts, the application of the securities laws would serve to bolster the well-defined body of fiduciary law spelled out in ERISA. Indeed, it is inconsistent with the "exclusive benefit rule" and potentially Sections 406(a)(1)(D) and 406(b) of ERISA for an investment manager to engage in a permissible cross-trade transaction if such manager knows that the price pursuant to which the trade was made would serve to disadvantage one client over another. *In short, if an investment adviser were to engage in the types of activities identified by the Department, the adviser would be criminally and civilly liable under an assemblage of federal and state law*. The Department, the SEC, the U.S. Department of Justice, the states, and most importantly, clients, would have ample legal means of redress under appropriate legal provisions.

In summary, the ICAA encourages the Department to use Rule 17a-7 as a framework for formulating exemptive relief for cross-trade transactions involving ERISA-covered accounts and to do so in light of the comprehensive body of existing law prohibiting an investment adviser from engaging in activities identified by the Department. The ICAA believes the use of Rule 17a-7 pricing and approval standards are essential to the development of appropriate exemptive relief for cross-trade transactions. Without consistency of regulation with respect to pricing and transactional approval, investment managers will be unable to provide their clients with the transactional cost relief available to non-ERISA investors. The need for such regulatory consistency is fundamental to any approach taken by the Department in proposing exemptive relief for cross-trade transactions.

Specific Issues

Set forth below are the ICAA's responses to the specific questions raised by the Department in the Notice.

1. You ask whether the development of a class exemption, which covers all types, or any type, of cross-trading programs, would be in the interests and protective of employee benefit plan investments.

As the Department has recognized in its Notice, cross-trading affords significant benefits to ERISA plans, including saving sums of money for client accounts by reducing brokerage commissions and avoiding the bid/ask differential in the price obtained for the securities. In addition, such cross-transactions provide for a more efficient implementation of investment strategies by allowing a fiduciary to buy a security the same day it is selling the same security for another account without the occurrence of market impact that might serve unintentionally to disadvantage one account in favor of another.

The ICAA believes the development of a cross-trade class exemption for all types of cross-trades would be in the interest of ERISA plans because it would enable plan clients to achieve cost savings similar to those realized by non-ERISA investors. Due to cost and execution efficiencies, today's trading systems are becoming more mechanical and unless the rules for ERISA clients are consistent with the rules for the investment industry generally, ERISA clients will be excluded from the benefits that mechanical systems offer, including the benefits of cross-trades.[13] In addition, the ICAA believes the rules for investment fiduciaries engaging in cross-transactions should be consistent regardless of the type of client involved. Consistent rules make sense because the same policy concerns are present regardless of the type of client involved

[13] In this respect, a mechanical trading platform necessarily must assume that the accounts available to trade securities are subject to uniform regulation in order to function. Accounts subject to differing regulation must be segregated to a separate platform thereby excluding the accounts from the trading opportunities and efficiencies available in the broader based platform. Differing sets of standards also result in the increased costs of maintaining multiple trading systems which are also likely to be passed on to investors.

or whether the transaction is accomplished through a cross-trade or not. The DOL and the SEC both seek to ensure that a fiduciary fulfills its duties to its clients and that the interests of investors are fully protected. The ICAA believes a class exemption based on the primary elements of Rule 17a-7 will allow plan clients to participate in cross-trade opportunities and the substantial transactional cost savings attendant thereto while at the same time being protective of their interests.

2. Question 2 inquires as to whether the Department should develop separate class exemptions for cross-trades of securities by (i) actively-managed accounts, and (ii) "process-driven" accounts.

As discussed above in our general comments and more specifically in our response to question 1, the ICAA believes uniform, workable conditions should be developed to make cross-trades generally available to ERISA plans and not limited to ERISA plans investing in "process-driven" index programs or on an actively managed transaction-by-transaction consent basis. Unlike exemptions for actively managed accounts, exemptive relief for process-driven index programs generally require that the cross-trade transaction occur within three days of a "triggering event," such as a change in composition or weighting of the index or model underlying a fund. The other conditions to which such exemptions are subject, such as the mechanism for pricing the securities and the reporting and disclosure obligations, are consistent with those applicable to actively managed exemptions. Accordingly, the exemptive relief afforded to cross-trades involving ERISA-covered accounts generally should be appropriate for a broad class exemption format. This would make the exemption available to all plans and their managers in the most efficient manner without creating competitive pressures based on management style.

The Department previously has limited its exemptive relief to circumstances designed to eliminate or limit the manager's discretion to effect cross-trades either because the cross-trades were generated through mechanical index driven trading programs or because each cross-trade transaction required specific client consent. However, requiring independent authorization of each cross-trade opportunity is a substantial impediment to conducting cross-trades for actively managed accounts. An exemption that permits discretionary cross-trading under conditions similar to those imposed by Rule 17a-7 would be no less protective of plans than other types of transactions involving fiduciary conflicts that have been exempted by the Department *without requiring a transaction-by-transaction consent*. For example, PTE 77-4 permits a fiduciary to purchase and sell shares of a registered investment company for which it serves as the adviser with independent fiduciary consent that is provided "prior to the commencement of a specified purchase or sale program in the shares of such investment company." 42 FR 18732, Apr. 8, 1977. PTE 82-63 permits a fiduciary to engage in discretionary securities lending activities for which the fiduciary receives compensation with the independent fiduciary's written standing authorization of the securities lending arrangement. 42 FR 14804, Apr. 6, 1982. Finally, PTE 86-128 permits a fiduciary to use an affiliated broker to effect securities trades directed by the fiduciary for additional compensation with the independent plan fiduciary's written standing authorization. The authorizing fiduciary also must be provided with confirms or regular reports summarizing the transactions effected under the exemption and the charges incurred by the plan. 51 FR 41686, Nov. 18, 1986.

The Department has not deemed it necessary in the above-referenced exemptions covering potential fiduciary conflicts essentially to *eliminate* the fiduciary's discretion by requiring a transaction-by-transaction consent or a mechanical procedure. The ICAA believes that, similar to the transactions described in such exemptions and other exemptions that have been granted by the Department, there is very little risk that a manager could use its discretion in a manner adverse to the interests of a plan client when effecting a cross-trade under conditions comparable to Rule 17a-7. Accordingly, there would be no need to develop separate class exemptions for cross-trades of securities by actively managed accounts and by process-driven accounts.

3. Question 3 asks whether the Department should develop consistent conditions in individual exemptions that then would facilitate the use of PTE 96-62.

As discussed in response to questions 1 and 2 above, the ICAA believes a class exemption is the best approach to address this industry-wide concern and will better ensure the availability of the benefits of cross-trade transactions to the widest segment of plan investors. A class exemption would make the benefits of cross-trading available to all ERISA plans and their managers in the most efficient and comprehensive manner consistent with the Department's Congressional mandate to grant exemptions from the prohibited transaction restrictions in order to ensure that ERISA's prohibitions do not "disrupt the established business practices of financial institutions which often performs [sic] fiduciary functions in connection with these plans consistent with adequate safeguards to protect employee benefit plans." H.R. Conf. Rep. No. 1280, 93d Cong. 2d Sess. 309 (1974).

4. You ask what effect, if any, will the following have on cross-trading programs: (i) the move to decimalization of stock quote spreads; (ii) the emergence of electronic proprietary trading systems; (iii) the growth of block trading in the so-called "upstairs market;" and (iv) other market developments.

The securities industry always is working actively to develop ways of reducing the costs and increasing the efficiency of trading through such means as electronic trading systems and the so-called "upstairs market" on securities exchanges. However, the ICAA does not anticipate that these securities industry developments will ever eliminate the importance of cross-trading as a means to achieve most fully the reduction of commissions and the bid/ask differential in the price obtained for securities. In this respect, while the move to electronic systems may serve to reduce commissions, such developments result from profit-driven enterprises and will not eliminate transaction costs entirely.

5. Question 5 asks whether the development of proprietary trading systems impact on the requirements for an exemption permitting cross-trading of securities by plans with the same investment manager.

The ICAA does not believe the use of a proprietary trading system involves a manager-instituted cross-trade within the scope of the Notice and, therefore, the use of these proprietary systems should not impact the requirements or need for an exemption for cross-trading.

6. Question 6 inquires as to whether there are "real savings" to plans from cross-trading when other market options are available.

See response to question 4. In addition, the options listed in question 4 are not available for many of the trades in which plans participate. Accordingly, cross-trading would be the only means to effect such cost savings. Therefore, there are real measurable savings to plans from cross-trading even with other market options available.

7. You ask what are the "costs" associated with doing a transaction "off market."

It is not clear what "costs" the Department is referring to in raising this question. As stated above, if cross-trades are subject to conditions consistent with SEC Rule 17a-7, which sets a formula for establishing an independent market price, "off market" cross trades should, by definition, only serve to benefit clients by relieving them of currently existing transaction costs associated with doing a securities trade. In addition to transaction costs such as commissions or spreads, cross-trading sometimes may reduce the market impact costs associated with trading in the open market. For example, where the trading desk of a financial institution is presented with simultaneous buy-and-sell orders for the same relatively illiquid security, the purchasing account may benefit from the downward pricing pressures caused when the sell order is placed in the market. We understand that at least some representatives of the Department have suggested this presents a "cost" of "off-market" trading because one account would have benefited from the market impact of the other's trade if it had been made in the open market. Such a conclusion ignores the fact that the securities laws impose a fiduciary duty on investment advisers to seek best execution for both accounts and prohibit an investment adviser from engaging in securities trades that serve to disadvantage one client over another.

Without the ability to enter into a cross-trade transaction, the investment adviser presented with simultaneous buy-and-sell orders has at least three options. The adviser could act in the sole benefit of the selling client and send the other client's buy order to the appropriate market center first, thereby driving the stock's price upward. The adviser then could send the sell order, taking advantage of the market impact from the buy order. Alternatively, the adviser could act in the sole benefit of the purchasing client, by reversing the timing of the orders. In such a situation, the selling client's execution would suffer due to the downward pressure on the stock price while the purchasing client would benefit from the market impact by purchasing the security at a lower price. Both of these scenarios result in one winner and one loser. Under the final scenario, the adviser would buy and sell on the open market in such a manner so as not to disadvantage either client. To accomplish this goal, the adviser could "work" both orders over time by breaking up the orders into smaller pieces. This strategy could help minimize the market impact of the transactions, but would delay final execution thereby subjecting both accounts to market volatility and, of course, would not allow the accounts to avoid the transaction costs associated with open market trades. Clearly, the fairest and more prudent thing to do in such a situation is to cross the trades – thereby saving the transaction costs and avoiding disadvantaging either client.

8. You ask whether trading by other investors on securities exchanges would be affected by the widespread use of cross-trading programs for securities transactions by employee benefit plans.

Since cross-trading is generally available to non-ERISA investors, allowing ERISA plans to participate in a practice that already is widespread in the investment industry should have no measurable impact upon non-ERISA investors. If each cross-trade is effected at the current market price for the security on the date of the cross-trade, the additional transactions could not have a market impact. Further, cross-trades by nature are market neutral since they involve the same number of securities on each side and, therefore, the increase in the number of cross-trade transactions should not have any impact on the market.

9. You ask whether cross-trades are beneficial when the securities involved represent a significant percentage of the average daily trading volume of securities.

As indicated in our response to question 7, not only are cross-trades beneficial when the securities involved represent a significant percentage of the average daily trading volume of securities, but a cross-trade is in fact almost certainly the fairest method for making the trade.

10. You ask how an investment manager who is a fiduciary of a plan with discretion in a cross-trade, who also has discretion for the other account in the same cross-trade, can act "solely in the interest" of the plan account.

As discussed above, the securities laws impose on investment advisers rules of conduct that are consistent with ERISA's "solely in the interest" requirement. In this respect, a fundamental obligation of an investment manager is to act in the best interest of all clients. When acting as a fiduciary for clients on both sides of a cross-trade, there must be an investment reason for both sides of the transaction. While not every simultaneous buy-and-sell order can be conducted permissibly by virtue of a cross-trade, there exist many situations where it is possible for both parties to benefit from a cross-trade. For example, there are occasions when one client is either scaling back a position or must raise cash, thereby providing an opportunity for another client to acquire that position with reduced transaction costs.

11. Question 11 inquires whether a cross-trade which avoids "adverse market impact" for one side of a transaction truly benefits both sides of that transaction.

Cross-trades generally do not impact the market and have the added benefit of eliminating commissions and/or narrowing the spread on OTC trades. As discussed above in connection with questions 7 and 9, to the extent a potential cross-trade would impact the market price of the security if the trade were to be made in the market, then it would disadvantage one account for the benefit of another. Therefore, the transaction should be conducted as a cross-trade.

12. You ask whether, in order to act in an employee benefit plan's best interest, an investment manager should attempt to negotiate a better price for a security before engaging in a cross-trade.

An investment manager (a fiduciary to the plan) is always obligated to seek best execution for its clients. In normal circumstances, a cross-trade with reduced transaction costs typically will result in better execution for both clients. The investment manager, of course, must use its external third-party information to price the transaction.

13. You ask whether it would ever be in an employee benefit plan's interest to purchase a security through a cross-trade that the plan otherwise would not have purchased.

We believe this is unlikely since such a purchase would have to satisfy the investment manager's fiduciary obligations imposed by ERISA, the Advisers Act, and other relevant regulations. It is irrelevant whether the stock is purchased through a cross-trade or in the open market.

14. Where an investment manager has performed an analysis of securities, you ask whether it would ever be in a plan's best interest to purchase a security through a cross-trade that was not otherwise the superior security as indicated by the investment manager's analytics.

Because of an investment adviser's fiduciary duties, a cross-trade should not be entered into where the reason one account is selling the security is because the manager believes the security no longer provides the requisite opportunity for gain or income. Rather, the typical situation is where the manager would prefer to continue to hold the security in the selling account, where the account has appreciated to an overly concentrated status, or because cash must be raised. Therefore, in the usual case, the manager's analytics already have indicated that the security should be held.

Only in situations where the "superior" security is not available for the respective account due to liquidity concerns, industry and sector limits, or other factors normally considered by the manager for that particular account, would an investment manager not purchase the "superior" security. In that situation, most investment managers normally will look to the next-best available security without any consideration as to whether it is available in a cross-trade. Of course, if the desired security is available in a cross-trade situation, then acquiring the security in such a manner typically would be in the client's best interest.

15. Question 15 asks if an employee benefit plan purchased a security through a cross-trade that was not the most appropriate security for the plan at the time of the transaction pursuant to an investment manager's model or index, could such a transaction then be viewed as being in the plan's best interests if the plan was adequately compensated for providing an accommodation to the selling entity and, if so, how could the market value of such an accommodation be determined by the investment manager.

Cross-trades are not executed in order to "accommodate" another client. Rather, both sides of the trade should, in the investment manager's determination, be benefiting from the trade.

16. You ask whether cross-trade programs tend to benefit larger accounts over smaller ones.

No, other than the higher potential for cross-trading frequency available that may result from the size of the account. Of course, because smaller accounts do not have the negotiating leverage of larger accounts, they are likely to pay "retail" rates of commissions and, thus, cross-trades actually may have a more significant cost savings potential for smaller accounts than larger accounts.

17. Question 17 inquires as to the best way to establish a price for cross-traded securities (*e.g.*, the "current market price" under SEC Rule 17a-7, the closing price for stocks traded on a nationally recognized exchange, the "volume weighted average price" for equity securities traded on an exchange, the average between the current "bid" and "ask" quotations from reputable independent dealers and market makers – particularly for debt securities where no exchange prices are available, etc.).

As mentioned in our introduction, the ICAA believes the fairest way to establish a price for cross-traded securities is through independent third party-pricing and a consistent methodology for the time and execution of the cross-trade pursuant to the requirements of Rule 17a-7.

18. You ask, given the variety of methods for trading equity securities and the fact that many trades are conducted after a particular exchange has closed for the day, what is the current understanding of the meaning of the term "closing price," as utilized as a condition in the Department's current individual exemptions.

The close of the market generally means at the close of the relevant local market where the security is traded.

19. You ask if volume restrictions on the number of shares of a particular security that can be cross-traded ameliorate the potential for abuse that may occur.

It is difficult to see how the pricing mechanism of Rule 17a-7, when considered together with disclosure rules and the application of fiduciary principles scrutinized by the Department and the SEC, would not be sufficient to protect plan investors whose sole wish is to avoid unnecessary transaction costs. We do not believe volume limitations would serve any useful purpose.

20. You ask whether computer models which "drive" portfolio selections made by a manager for an index or model-driven fund are capable of being manipulated by such managers in order to produce more cross-trade opportunities for a particular fund.

We express no opinion on this question at this time.

21. You ask what degree of discretion is provided to investment managers of index or model-driven funds to affect more or less cross-trade opportunities.

We express no opinion on this question at this time.

22. You ask if exemptions for cross-trading programs involving employee benefit plans provide a commercial advantage to investment managers with larger amounts of assets under management and, if so, to what extent.

As discussed above, cross-trading programs benefit clients in the form of reduced transaction costs and provide no direct financial incentive to investment managers. Moreover, opportunities for cross-trades do not arise in a consistent or contemplative manner but, rather, as the result of investment decisions totally removed from the cross-trade. For example, a cross-trade opportunity might result when a stock held by an account with a "small cap" investment guideline reaches a capitalization level that is inconsistent with the guideline but would represent an attractive and appropriate investment opportunity for another account. In this respect, it appears more likely that cross-trading opportunities arise as a function of the portfolio's investment philosophy and guidelines than due to the size of assets under management. Finally, transaction cost savings are just one factor that clients examine when appointing an investment manager, with the primary factor obviously being investment performance. Thus, an investment manager with a smaller investment portfolio but a record of good performance should be at no competitive disadvantage.

23. You ask if an efficient cross-trading program could provide an investment manager with commercial advantages over competitors who do not choose to have, or are unable to implement, such programs and, if so, to what extent.

The ICAA believes the issue of whether an adviser offers a cross-trading program is a factor that clients consider when selecting discretionary managers. Accordingly, one could argue that under the current environment, where not all advisers have been issued cross-trading exemptions, a competitive advantage may exist for such firms.[14] Assuming the Department adopts an exemption meeting the conditions described above, it is unlikely an investment manager would not be able to implement a cross-trading program and, therefore, any competitive advantages would be eliminated.

24. You ask whether cross-trading of securities can be used by managers with discretion on both sides of the transaction to "dump," "cherry-pick," "front run," favor particular accounts, or

[14] The Notice identifies individual exemptions the Department has issued for cross-trades of securities as well as individual exemption applications requesting relief for cross-trading programs which the ICAA the Department has put on hold for an extended period of time pending resolution of the very same issues identified in the Notice. *See,* 63 FR 13696 at n. 6 and 13697 at n. 8. The ICAA understands, however, that the individual exemptions granted for actively managed portfolios are generally too restrictive to be of any practical use.

otherwise provide a benefit to the investment manager or others at the expense of the employee benefit plan client.

As discussed above, a cross-trade transaction priced in accordance with Rule 17a-7 should, by definition, be effected at a price that offers little or no incentive for a manager to "dump," "cherry-pick," or favor one account over the other. Moreover, an investment adviser that engages in such activities violates Section 206 of the Advisers Act and breaches its fiduciary duties to the client account. *The ICAA does not believe there is anything unique about cross-trades involving ERISA accounts that will serve to promote activities such as "dumping," "cherry-picking," and "front-running"*[15] *and encourages the Department to weigh such concerns against the potential for transactional cost savings for ERISA-covered investors and in light of the comprehensive body of existing law which prohibits an investment adviser from engaging in such activities.*

25. Finally, you ask what new terms or conditions the Department could impose in an exemption to protect plans involved in cross-trading from potential abuses.

The ICAA believes any class exemption should adopt the primary elements of Rule 17a-7 identified above. Any additional conditions necessarily must not conflict with the provisions of Rule 17a-7 and must not serve to act as a disincentive to making cross-trading opportunities available to plan accounts.

* * *

On behalf of the ICAA membership, we wish to thank you for the opportunity to respond to the Department's request for comments. The need for a practical class exemption to permit cross-transactions involving ERISA-covered accounts has been on the table for some time and

[15] In fact, as discussed above, failure to permit such transactions actually makes it easier for unscrupulous advisors either to "cherry-pick" or "dump" securities by manipulating the time and size at which orders are exposed to the market.

the ICAA strongly believes the time has come for the Department to adopt a workable rule that is consistent with the manner in which cross-trades are handled for mutual funds and that puts ERISA-covered investors on the same footing as other institutional investors. If you have any questions or if the ICAA can be of additional assistance in formulating a practical rule for cross-trade transactions, please contact the undersigned or Karen L. Barr, ICAA General Counsel.

Sincerely,

David G. Tittsworth
Executive Director

cc: The Honorable Arthur Levitt
The Honorable Isaac C. Hunt, Jr.
The Honorable Norman S. Johnson
The Honorable Paul R. Carey
The Honorable Laura S. Unger
Mr. Barry P. Barbash

July 6, 1998

Robert E. Plaze, Esq.
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Investment Management
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Re: Revisions to the Books and Records Provisions

Dear Bob:

We understand that the SEC's Task Force on Investment Adviser Regulation ("Task Force") is currently reviewing the books and records rule[1] for the purpose of determining whether to amend the rule.[2] The Investment Counsel Association of America[3] respectfully suggests that the Task Force propose amending Rule 204-2 to clarify an adviser's obligations with respect to three issues that frequently cause confusion: (1) retention of documents that relate to recommendations or advice; (2) retention of publicly available documents; and (3) the extent to which documents may be stored electronically.

Rule 204-2(a)(7)

Rule 204-2(a)(7) requires an adviser to keep all "written communications" received and sent that relate to recommendations or advice given or proposed to be given. This rule has caused considerable confusion. Some advisers believe the provision is intended simply to capture correspondence with clients and others regarding an adviser's recommendations.[4] Other advisers interpret the rule more broadly to require retention of all documents relating to each and every security analyzed by advisers in the process of

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[1] Rule 204-2 of the Investment Advisers Act of 1940.

[2] *See, e.g.* Securities and Exchange Commission Semiannual Regulatory Agenda, 63 Fed. Reg. 23060 at 23066 (April 27, 1998).

[3] 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 $1.5 trillion for a wide variety of institutional and individual clients.

[4] This interpretation is supported by the "received" and "sent" terminology used in the rule. The rule on its face does not require retention of internally created documents that support recommendations.

making investment decisions.[5] These advisers therefore retain every document they receive, including research reports, annual reports, Forms 10-K, 10-Q, and 8-K, prospectuses, newspapers, and periodicals. The disparity in these interpretations obviously causes vast differences in recordkeeping practices. We therefore urge the Task Force to clarify the intent of this rule.[6]

Publicly Available Documents

Rule 204-2(a)(7) contains a proviso that advisers are not "required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser." It is not entirely clear which types of documents the proviso applies to, in part because (1) it is unclear whether the "other similar communications" also must be "unsolicited;" and (2) the term "general public distribution" may be slightly more narrow than "publicly available." In addition, certain no-action letters appear to imply that at least some publicly available documents must be retained.[7] In an abundance of caution, as noted above, many advisers keep all publicly available documents that are received in the process of analyzing securities, including annual reports, Forms 10-K, 10-Q, and 8-K, prospectuses, press releases, and news articles. As you can imagine, these advisers are drowning in a sea of unnecessary paper.

We therefore suggest that in the revisions to Rule 204-2, the Task Force clarify that advisers need not keep any publicly available documents, whether solicited or unsolicited. It would be helpful if the rule or adopting release contained clarifying examples of "publicly available documents," including, at a minimum, all documents filed with the SEC, documents sent by publicly held companies to all shareholders, press releases, news wire reports, and newspapers.

Electronic Storage of Documents

Rule 204-2(g) does not explicitly permit an adviser to electronically store documents that it receives on paper. Numerous advisers, however, electronically scan documents onto computerized databases in reliance on staff no-action positions.[8] In light of the significant technological advances that have occurred since Rule 204-2(g) was issued, we suggest that the Task Force revise Rule 204-2(g) to permit firms greater

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[5] This interpretation is supported by some no-action letters that appear to imply that advisers must keep all research reports and other documents related to analyzing securities. *E.g., First Call Corporation* (pub. avail. Sept. 6, 1995); *Disclosure Incorporated*, No-Action Letter (pub. avail. Aug. 22, 1996).

[6] In addition, we encourage the Task Force to clarify what constitutes a "written communication received" in this age of electronic advances. Many portfolio managers rely on constantly changing data that appears on their computer screens regarding price and company news from sources such as Bloomberg. It would be virtually impossible to continuously print out the information appearing on these screens. Yet some advisers are concerned that they might be required to do so because the information might be deemed a "communication received … relating to" recommendations.

[7] *See, e.g. Disclosure Incorporated*, No-Action Letter (pub. avail. Aug. 22, 1996).

[8] *E.g. Oppenheimer Management Corporation* (pub. avail. Aug. 28, 1995).

flexibility in using new technologies to satisfy recordkeeping obligations, subject, of course, to appropriate safeguards.

Thank you for your consideration of these suggestions. Please do not hesitate to contact me at (202) 293-4222 if you require any additional information.

Sincerely,

Karen L. Barr
General Counsel

cc: Barry P. Barbash, Director, Division of Investment Management
Catherine M. Saadeh, Task Force on Investment Adviser Regulation, Division of Investment Management

August 10, 1998

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

Re: Release IA-1728, IC-23293, File No. S7-20-98, Investment Adviser Year 2000 Reports

Dear Mr. Katz:

The Investment Counsel Association of America ("ICAA") appreciates the opportunity to comment on the Securities and Exchange Commission's proposed new rule and form under the Investment Advisers Act of 1940 regarding the Year 2000 computer problem.[1] The proposal would require most registered investment advisers to file two reports on Form ADV-Y2K with respect to their Year 2000 readiness.[2] The first report would be due 30 days after the rule becomes effective and the second report would be due eight months from the date of the first filing. The reports would be publicly available.

As proposed, Form ADV-Y2K contains two parts. Part I must be completed by virtually all registered advisers.[3] It requests information principally regarding (1) the scope and status of the adviser's Year 2000 compliance plan; (2) the commitment by the adviser of resources and personnel to the problem; (3) systems that may be affected by the Year 2000 problem; (4) progress on implementing the Year 2000 plan; (5) contingency plans in case the adviser experiences Year 2000 problems after December 31, 1999; and (6) the readiness of third parties upon whom the adviser relies for critical systems. Part II contains substantially identical questions and must be completed by advisers to registered mutual funds.

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[1] The ICAA is a national not-for-profit association that exclusively represents federally registered investment adviser firms. Founded in 1937, our membership consists of more than 225 investment advisory firms that collectively manage funds in excess of $1.5 trillion for a wide variety of institutional and individual clients.

[2] SEC Release No. IA-1728; IC-23293; File No. S7-20-98 (June 30, 1998) ("Release IA-1728").

[3] All ICAA members would be required to complete and file at least Part I of proposed Form ADV-Y2K because all member firms are SEC-registered and manage client assets in excess of $25 million.

The ICAA supports the Commission's efforts to achieve Year 2000 compliance by ensuring that investment advisers, investment companies, broker-dealers, transfer agents, and public companies take appropriate steps to evaluate and remedy potential problems. Computer problems caused by the Year 2000 glitch may have a very serious effect on both individual businesses and the U.S. and global economy.[4] Many concerned investors have requested information from their investment advisers regarding the status of their advisers' Year 2000 readiness. Information about the Year 2000 preparedness of participants in the securities business would be helpful not only to investors, but to the industry as well. For example, many investment advisers welcome the opportunity to review the Year 2000 reports that will be filed by the broker-dealers and transfer agents[5] on which advisers rely for essential services.

The ICAA also is aware of the extensive Year 2000 interviews that the Commission's regional offices are currently performing with respect to investment advisers and investment companies. From reports we have received from a number of our member firms, the targeted Year 2000 inspections will enable the Commission to gain valuable information concerning Year 2000 readiness in the investment advisory industry and will serve to increase the industry's awareness of the issues involved.

With that in mind, the ICAA has the following suggestions and comments to make Form ADV-Y2K more helpful and user-friendly to both advisers and the Commission.

Affiliates should be permitted to file one report where appropriate.

The proposed rule would require each registered investment adviser to file the Year 2000 reports. The instructions to Part I direct the registrant to include in its answers any investment adviser affiliates that are *not* required to file the report (presumably because they are state-registered or exempt from SEC or state registration). The proposal does not permit a registrant to include in its answers its SEC-registered affiliates, which would otherwise be required to report separately.

Numerous registered investment advisers, however, are affiliated through a holding company structure, or through a principal U.S. adviser with SEC-registered offshore or domestic affiliates. In many instances, the Year 2000 preparations are coordinated through one comprehensive plan at the holding company or principal adviser level, not through each separate registered entity. We respectfully suggest that the instructions be amended to permit a holding company or principal adviser to file one report for all of its affiliates where that entity is coordinating the Year 2000 effort. This

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4 *See, e.g.,* Prepared Testimony of Dr. Edward Yardeni, Chief Economist & Managing Director, Deutsche Morgan Grenfell, Hearing on Disclosure of Year-2000 Readiness, before the Subcommittee on Financial Services and Technology of the Senate Banking, Housing and Urban Affairs Committee (June 10, 1998).

5 *See* Reports To Be Made By Certain Brokers and Dealers, SEC Release No. 34-40162; File No. S7-7-98 (July 2, 1998); Year 2000 Readiness Reports To Be Made By Certain Transfer Agents, SEC Release No. 34-40163; File No. S7-8-98 (July 2, 1998).

will eliminate needless paper and duplicative efforts. For example, when a holding company owns four investment advisers, one report would be filed rather than four separate entirely duplicative reports. The report could include space to list affiliates on whose behalf the report is being filed, or the instructions could require the holding company to submit separate cover pages for each affiliate. If the holding company is not a registered entity, it could designate one principal adviser to file on behalf of all affiliates.

Part II should be modified to reflect the organization of investment companies.

Part II of proposed Form ADV-Y2K contains virtually identical questions to Part I, and must be completed by advisers to a registered mutual fund or complex of funds. As currently structured, Part II does not fit the reality of how most investment companies operate. An investment company is, in essence, a pool of money/investments with a Board of Directors. A fund generally does not have its own employees, facilities, or computer systems. Instead, funds are operated by, and use the computer systems of, their sponsoring advisers or administrators. Funds also rely on the computer systems of their custodians, transfer agents and broker-dealers. Therefore, a fund likely would not have its own Year 2000 plan. Rather, the fund would be part of the adviser's or administrator's overall plan, and would also rely on the plans of other third parties.

Accordingly, the answers to Part II may be confusing or misleading. Depending on how the adviser reads Part II, an adviser whose fund is included only in the adviser's plan may answer "no" to questions such as whether the investment company has a Year 2000 plan, whether the fund has a contingency plan, and whether the fund is staffing the project. Or such an adviser may provide answers to Part II that are entirely duplicative of its answers to Part I. Under either scenario, Part II, as proposed, is not relevant or helpful to either the Commission, the industry, or investors.

We suggest that Part II be substantially simplified to address principally how fund boards are monitoring the Year 2000 efforts of their advisers or other third party administrators. Part II should require an adviser to identify the funds with respect to which it is responding and ask whether those funds are being covered as part of the adviser's overall plan described in Part I. If the answer is yes, the adviser only should be required to answer a series of questions about board oversight. If the answer is no, the form should require the adviser to explain in more detail how the fund is being covered.

The instructions should include a presumption that the adviser, not the subadviser, will complete the reports for investment companies.

The instructions to proposed Form ADV-Y2K would require an adviser or subadviser to a registered fund to complete Part II with respect to that fund and funds in the same complex unless another adviser is filing the form for that fund or complex. Subadvisers, however, generally are not in a position to know about the overall operations of the fund. Typically, the adviser handles the administration of the fund, while the subadviser participates only in investment management of all or a portion of the fund. Therefore, we suggest the instructions include a presumption that the adviser, not the subadviser, must file Form ADV-Y2K with respect to the funds it advises. Such a presumption will minimize confusion, while still permitting the subadviser to file the form pursuant to an agreement with the adviser. Similarly the instructions could explicitly include a presumption that the adviser (or other registered entity) with the most administrative and operational responsibilities for a fund or fund complex must file Form ADV-Y2K with respect to that fund or complex.[6]

The instructions regarding contingency plans should be clarified.

The release discussing the proposal states that “contingency plans should provide for the failure of external systems,” such as those of a vendor or investor.[7] It is possible that an adviser can plan for the failure of a vendor’s system. Other external systems, however, do not lend themselves to contingency plans. For example, an adviser may not be able to plan adequately for industry-wide problems, such as a failure at the New York Stock Exchange, DTC, or NASDAQ. Similarly, city-wide problems, such as a failure of electricity or telephone services do not appear amenable to contingency planning.

We therefore suggest that the Commission clarify that the questions regarding contingency planning refer only to internal systems and to those external systems that are individually related to the adviser. Alternatively, the release could specifically exclude industry-wide or geographically related systems. Similarly, the release could clarify whether industry-wide or city-wide systems should be included in an adviser’s analysis of “mission-critical” systems. We believe it is appropriate for the Commission to issue more specific guidelines that indicate the scope of contingency planning issues and outline areas the Commission believes are most critical in addressing external matters outside the direct control of the adviser.[8] A more definitive set of contingency planning guidelines would help to advance the goals of Form ADV-Y2K and ensure that advisers focus on specific areas deemed to be of most critical importance by the Commission.

The form’s staffing questions should refer to full-time equivalents.

As proposed, questions 4(a) and (b) request information about the number of individuals working full time on Year 2000 compliance issues. There are no questions that request information about employees working part time on Year 2000. As a result, responses to question 4 may be substantially misleading. A firm that employs ten computer experts, each of whom is working 75% on the Year 2000 issue and 25% on other issues (such as the Euro conversion) would have to answer “no” to question 4(a)

[6] This concept is discussed in Release IA-1728 at p. 8, but is not mentioned in the instructions to Form ADV-Y2K.

[7] Release IA-1728 at p. 8, n.15.

[8] For example, the discussion in Release IA-1728 at p. 8, n. 15 could be expanded into greater detail and perhaps be moved into the text.

and skip question 4(b).[9] Such a response would provide no information (and permit inappropriate inferences to be drawn) about the firm's staffing. Accordingly, we suggest that question 4 explicitly refer to full-time equivalents, or that an instruction be included permitting firms to answer question 4 on the basis of full-time equivalents.

The rule should address liability concerns.

Proposed Form ADV-Y2K requires yes/no or other specific answers in response to questions that involve subjective considerations. For example, the Form asks whether implementation of the adviser's Year 2000 plan is 0%, 1-25%, 26-50%, 51-75%, 76-99%, or 100% complete. The answer to such a question can only be subjective or a best estimate, yet the question is not posed as an estimate. Similarly, the assessment of which systems are mission-critical is subjective and the Commission has not set forth any objective criteria for advisers to make that assessment.

We are concerned that the requirement of objective answers to subjective questions may lead to litigation and/or liability for advisers. Liability concerns may also lead advisers to respond overly conservatively to the questions, perhaps presenting a bleaker picture of Year 2000 readiness to investors than is warranted. Presumably based on similar concerns, the Commission has provided some measure of protection for public companies in its Interpretive Release No. 33-7558; IA-1738; IC-23366 (July 30, 1998), by bringing much MD&A Year 2000 discussion within the statutory safe harbor for forward-looking information.[10] The ICAA respectfully suggests that the Commission include in its release some measure of protection for investment advisers as well. For example, the Commission could explain in its release or instructions that, with respect to certain questions, it is requiring only a good faith estimate, or with respect to undefined terms, a good faith assessment of subjective issues. In the absence of concrete examples or defined terms in Form ADV-Y2K, we suggest that the goals of requiring the Form will be best achieved only if the Commission clearly enunciates a standard for responses that will minimize liability concerns that will arise when advisers provide good faith estimates.

Form ADV-Y2K's questions regarding each firm's proprietary budget numbers may also lead to liability problems.[11] These budget allocations are meaningless except in the context of what each adviser must do to become Year 2000 compliant, and therefore do not reflect Year 2000 readiness. For example, an adviser that replaced all of its

[9] Indeed, we understand from our members that many of the most talented information technologists do not want to work exclusively on Year 2000 issues. Because such talent is scarce in this market, firms are making sure that their employees' desires are being met in this area.

[10] Interpretive Release No. 33-7558; IA-1738; IC-23366; International Series Release No. 1149, Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers (July 30, 1998).

[11] *See* proposed Form ADV-Y2K, Question 2, titled "Funding for Year 2000 Compliance," Release No. IA-1728 at p. 26.

systems in the last few years would have to spend much less than an adviser with entirely old systems. Or a small adviser that relies entirely on external systems may have to spend very little on Year 2000 compliance. Similarly, a firm that had the foresight to begin addressing the problem in 1996 or 1997 may have relatively low Year 2000 allocations for fiscal years 1998-2000. Nevertheless, potential litigants may compare apples with oranges by seizing on these public budget numbers to charge that some firms breached their fiduciary duties by failing to devote as many financial resources to the problem as other firms. We respectfully suggest that the Commission address this concern by either (1) permitting firms to submit budget numbers confidentially or (2) educating investors in the adopting release or Form ADV-Y2K that the question is intended to assess materiality, and that Year 2000 budget allocations are not necessarily indicators of Year 2000 compliance or readiness.

Attestation by an independent public accountant is not appropriate.

As proposed, Form ADV-Y2K would require execution by "an authorized person that participates in managing or directing the adviser's affairs," but would not have to be attested to by an independent public accountant. The Commission requested comment on whether to require such attestation.

The ICAA supports the Commission's current proposal not to include the attestation. We are concerned that independent public accountants may not have sufficient expertise to perform audits of computer systems rather than financial statements. Accountants may be no better qualified to review and inventory an adviser's internal and external computer systems than the adviser's information technology consultants and staff. Thus, such a requirement would impose undue costs and burdens on advisers without providing substantial offsetting benefits to the Commission or investors.

Moreover, the currently proposed requirement of execution by a senior person within each advisory firm adequately will ensure that the upper management of each firm has carefully reviewed the firm's Year 2000 efforts and responses.

The ICAA supports the proposal's qualitative approach.

The proposed form would require advisers to take a "qualitative average" of their systems to assess and report their Y2K progress. The Commission has requested comment on this approach, including whether a system-by-system approach is preferable. The ICAA supports the qualitative approach as proposed because it would not only provide flexibility, but also cause advisers to examine and evaluate their overall operations and Year 2000 efforts to ensure "big picture" prioritization of issues.

The ICAA appreciates your consideration of these comments. As always, we stand ready to work closely with the Commission and other parties to ensure that all investment advisory firms are taking timely and appropriate steps to achieve Year 2000 compliance. Please do not hesitate to contact the undersigned or David G. Tittsworth, Executive Director, at (202) 293-4222 with any questions concerning these important issues.

Sincerely,

KAREN L. BARR
General Counsel

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

September 23, 1998

Mr. Barry P. Barbash
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Establishment of Centralized Reporting System for Investment Advisers

Dear Barry:

The ICAA[1] is writing this letter regarding the Commission's ongoing efforts to establish a centralized reporting system for investment advisers. While the basic concept of a centralized reporting system has merit, we believe the devil is in the details of how – and by whom – such a system is administered. Accordingly, we strongly urge the Commission to involve the ICAA and other appropriate industry groups at the earliest opportunity in its deliberations to provide ample opportunity for comment, debate, and resolution of relevant issues.

It is well known that the Commission – in conjunction with the North American Securities Administrators Association – has for the past several months been in the process of discussing the establishment of a centralized reporting system for investment advisers. While the concept of such a system has been discussed in general terms for many years, provisions of the Investment Advisers Supervision Coordination Act[2] provided additional urgency and currency to the concept. For example, the law granted the Commission explicit regulatory authority to require an investment adviser "to file with the Commission any fee, application, report, or notice required by this title or by the rules issued under this title through any entity designated by the Commission for that purpose" (and to pay reasonable costs associated with such filing).[3] Other provisions required the Commission to "provide for the establishment and maintenance of a readily accessible telephonic or other electronic process to receive inquiries regarding

[1] The Investment Counsel Association of America, Inc. is a not-for-profit association that exclusively represents federally registered investment adviser firms. Founded in 1937, our membership today consists of more than 230 firms that collectively manage assets in excess of $1.5 trillion for a wide variety of institutional and individual clients.
[2] Title III of the National Securities Markets Improvement Act of 1996, P.L. 104-290, October 11, 1996.
[3] Section 203A(d), Investment Advisers Act of 1940.

disciplinary actions and proceedings involving investment advisers and persons associated with investment advisers."[4]

Last year, we wrote to NASAA and expressed our general support for the *concept* of a centralized reporting system, while expressing significant concerns about the details of how such a system is to be implemented.[5] For example, we expressed concern about the then-parallel efforts of NASAA and the SEC regarding development of a centralized reporting system. It is our understanding that the Commission and NASAA have worked together during the past several months to ensure that there will be only one centralized system. We also expressed significant concern about the costs of creating and maintaining a centralized system and conditioned our support for it "on learning more about whether there will be substantial costs that could outweigh the benefits of the system." We continue to be receptive to any information the Commission and NASAA could provide to us concerning the proposed system and its associated costs.

We would like to take this opportunity to voice an additional concern. Recent press reports have indicated the Commission seriously is considering designating NASD Regulation, Inc. as the entity that will administer the new centralized reporting system. We understand there may be administrative and cost-related reasons justifying such a decision. Even if the Commission finds that such reasons exist, we are nonetheless concerned NASDR may view the centralized reporting system as a chance to increase its regulatory reach into practices of investment advisers who are – and who should remain – primarily regulated by the Commission under the Investment Advisers Act of 1940.

In a letter to Commission staff late last year,[6] NASDR staff stated there have been "innumerable changes" in the manner in which securities are sold in the U.S. by both broker-dealers and investment advisers and that "these rapid developments threaten to overtake regulatory changes and that they require prompt consideration to assure that the interests of investors are fully protected." The clear implication of the letter and accompanying memorandum is that – at a minimum – certain investment adviser practices should be regulated by NASDR. We do not wish to raise issues that may have been considered by the Commission staff and rejected. If, however, NASDR is designated by the Commission to develop the centralized reporting system, we strongly urge you to explicitly clarify with NASDR that its function in administering the system will be strictly ministerial in nature and to have an understanding that such ministerial role will in no manner be construed to involve any of the Commission's regulatory oversight of or authority over investment advisers. Such an understanding would be consistent with the Investment Advisers Supervision Coordination Act, which reflected Congressional approval of allocating regulatory authority between the SEC and the states, instead of creating a self-regulatory organization for investment advisers.

[4] Section 306, Investment Advisers Supervision Coordination Act.
[5] August 20, 1997 letter from Karen L. Barr, ICAA General Counsel to Neal E. Sullivan and Karen O'Brien (copy attached).
[6] December 9, 1997 letter from R. Clark Hooper, Senior Vice President, NASD Regulation, Inc. to Barry P. Barbash, Esq. and Dr. Richard R. Lindsey (transmitting a December 8, 1997 memorandum from Thomas M. Selman, Joseph E. Price, and Lawrence N. Kosciulek regarding "Evolving Distribution Channels and their Regulatory Impact").

We would welcome the opportunity to receive information from the Commission and NASAA concerning the current status of efforts to establish a centralized reporting system for investment advisers. I appreciate your consideration of these important issues and trust you will not hesitate to contact me or Karen Barr, ICAA General Counsel, if we may be of any assistance to the Commission or NASAA concerning these matters.

Sincerely,

DAVID G. TITTSWORTH
Executive Director

Enclosure

Cc: Robert E. Plaze, Esq.
R. Clark Hooper, Esq.
Karen O'Brien, Esq.

December 17, 1998

Ms. Pauline Pilate
Association for Investment Management
and Research
P.O. Box 3668
Charlottesville, VA 22902

Re: Comments on Proposed Global Investment Performance Standards

Dear Ms. Pilate:

The Investment Counsel Association of America truly appreciates the opportunity to provide comments on the proposed Global Investment Performance Standards (GIPS). We commend AIMR and the GIPS Committee for their historic work in this important area and wish to emphasize our willingness to play a constructive role in the development of global standards. We also congratulate AIMR on the open process it has established for comment and dialogue on the GIPS proposal.

The ICAA is a national not-for-profit trade association that consists exclusively of federally registered investment adviser firms. Formed in 1937, the ICAA's membership today consists of more than 230 firms that collectively manage in excess of $1.5 trillion for a wide variety of institutional and individual clients. All ICAA member firms endorse our *Standards of Practice*, which emphasize the fiduciary obligations owed by advisers to their clients. Originally set forth in the ICAA's Code of Professional Conduct in 1937, principles set forth in the *Standards of Practice* have been used by Congress and the SEC as the basis for laws and regulations governing the conduct of investment advisers and by the U.S. Supreme Court in defining standards of fiduciary responsibility applicable to all advisers. In addition to promoting high standards of integrity, public responsibility, and competence in the investment adviser profession, the ICAA's mission focuses on representing the industry at all levels of government for the development, formulation, and enactment of appropriate legislation relating to investment advisers and promulgation of rules and regulations thereunder.

Over the years, the ICAA has played a leading role in the development of performance measurement and use standards. In 1972, the ICAA first published its "Standards of Measurement and Use for Investment Performance Data." The ICAA standards are relatively simple, flexible guidelines designed to provide minimum, uniform methods for performance measurement and presentation. These groundbreaking guidelines assisted advisers in producing relevant and comparable performance numbers. Some ICAA members and other advisers still use these standards today in measuring performance.

Recognizing the importance of widely accepted standards, the ICAA engaged in a dialogue with AIMR when AIMR was formulating its Performance Presentation Standards (PPS) many years later. Unfortunately, despite common goals, the ICAA and AIMR ultimately were unable to reach complete agreement on one set of standards, because of differing philosophies regarding a few key issues. Those issues included: (1) the PPS requirement that composites be asset-weighted (as opposed to equal-weighted); and (2) the PPS requirement that all discretionary fee-paying accounts be included in at least one composite.

Consistent with the Association's historic view of performance standards, the ICAA fully supports the concept of global standards. The ICAA also endorses the concept of having one consistent set of standards for performance calculation and presentation. Multiple sets of standards benefit neither advisers nor investors.[1] We agree with AIMR that widely accepted global standards would help to "ensure accurate and consistent investment performance data [and] … promote fair global competition between investment firms among all markets…"[2] Such standards would also assist in presenting investors with fair, complete, and comparable data, thereby increasing investor confidence in performance results. Accordingly, the ICAA would like to be able to endorse GIPS generally in a public manner and to endorse GIPS specifically to our members internally. We also believe that GIPS may offer an opportunity for the ICAA and AIMR to resolve their prior differences over certain elements of PPS. Thus we have included comments here that relate not only to the GIPS proposal, but to corresponding provisions in PPS as well.

The ICAA has the following comments regarding the GIPS proposal:

1. **Verification**

The GIPS proposal would provide for only one level of verification and would eventually make verification mandatory in the year 2005. We understand what AIMR is attempting to achieve with this proposal, particularly considering the wide disparity among performance standards globally. However, the verification aspect of GIPS has generated very significant concern among our members, principally based on a cost-benefit analysis. Currently, verification procedures are quite extensive and the cost of verifying even one composite is significant. Given the complexities and costs of verification, many - perhaps even most - of our members who claim AIMR-PPS compliance currently do not verify.

[1] In a similar vein, the ICAA has written numerous comment letters to various regulators and industry groups advocating one consistent set of standards in connection with issues such as soft dollars, cross-trades, and regulation of investment advisers by the various states.

[2] GIPS Proposal, Introduction, Paragraphs 7-8.

The GIPS proposal raises verification procedures to a level of even greater depth and complexity.[3] Thus, "strongly encouraging" and eventually requiring firms to follow GIPS' extensive verification procedures for the entire firm – and for all composites – would raise the costs of verification to unacceptable levels. The costs of such verification undoubtedly will deter many firms from becoming GIPS compliant, which is contrary to our common goal of contributing to a more widely accepted industry standard and a more uniform global marketplace.[4] Moreover, most firms do not market all of their composites. Thus, requiring verification of all composites would add significant costs without serving investor protection or other compelling justifications.

Further, independent verification may not be necessary in all instances. The GIPS proposal merely sets forth very general standards governing the knowledge required of auditors. Many ICAA member firms employ in-house auditors and performance analysts who are just as effective and sometimes far more knowledgeable and qualified regarding performance calculations and presentation than the outside auditors who are hired and paid to conduct verification. We believe the verification industry is not yet well organized enough to conduct consistent, efficient, and effective verifications; more work must be accomplished in this area before changes to the current PPS regime are considered.

The core goal of GIPS is to encourage firms to use a standard methodology for computing and presenting composite performance. The verification process should be a confirmation of those processes and not a substitute by which the adviser relies on auditors for computing performance. If firms are required to have all composites verified, then some firms may be tempted to become reliant on this process and not build adequate internal systems and controls. Further, firms may attempt to save money by "rolling up" their current products and composites into more broad-based composites (*e.g.*, one U.S. equity composite instead of small cap, large cap and growth and income composites), thereby diluting the quality of performance information and comparability.

We strongly encourage AIMR either to retain the current voluntary two-level verification system - set forth in PPS - for GIPS, or otherwise permit firms to verify only composites that actually are marketed to clients, similar to the system proposed in AIMR's Verification Subcommittee Report in 1995. At a minimum, we urge AIMR to conduct a cost-benefit study of verification before any action is taken on the proposal.[5]

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[3] The GIPS verification procedures require complete verification in some instances where PPS permits sampling. For example, under the heading "Nondiscretionary Accounts," GIPS requires verifiers to review every single contract – amounting to thousands for larger firms – to confirm whether accounts are discretionary. This hugely expensive proposition is unnecessary. An appropriate sampling would be much more appropriate and cost-effective.

[4] It also is not clear how frequently firms would have to verify. We recommend that AIMR state clearly the frequency of verification that it expects to mandate under GIPS (presumably once per year).

[5] We note that most government regulations, including comparable rules proposed by the Securities and Exchange Commission, must provide a cost-benefit analysis. We also note that some of our members, including some who currently claim AIMR compliance, oppose verification entirely – whether as a recommended or mandatory item.

2. All Accounts Included in a Composite

Under GIPS and PPS, all fee-paying, discretionary accounts must be included in at least one composite.[6] Again, in the interest of gaining more adherents to common standards, we suggest that AIMR permit more flexibility in this area. There are numerous situations where it does not make sense – or indeed would be misleading – to include certain unique or unusual accounts in a composite. The solution AIMR seems to suggest in this situation is to create a composite consisting of one account. Such a composite is not particularly useful. Most firms do not use such composites in marketing, yet, under GIPS, they would have to pay to have such composites verified.[7] These unique "composites" do not provide comparable, relevant data to investors.

Similarly, under both PPS and GIPS, advisers must include pooled vehicles such as mutual funds in at least one composite to claim PPS or GIPS compliance. We suggest that both PPS and GIPS permit firms to exclude registered mutual funds from their composites. Firms should be able, at their discretion, to treat mutual funds differently because they are already subject to very specific SEC rules on performance results.[8] Investors can easily compare and contrast mutual fund results, outside of PPS or GIPS. Moreover, by their very size, nature, and restrictions, such as Internal Revenue Code restrictions, mutual funds differ from separate accounts and their performance may have little relevance to a separate account client.[9] For example, many funds marketed to retail clients have significant outflows of cash through redemptions, seriously affecting the performance of such funds and the comparability of the data to separate accounts managed with similar strategies. Thus, granting firms flexibility in this area would not diminish investor protection or the "purity" of performance results.

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[6] *See id.* at 3.A.1.

[7] *See* Item 1, above, discussing the costs of verification.

[8] *See, e.g.*, Rule 482 under the Securities Act of 1933. For the same reason, it is not necessary to have mutual fund results verified.

[9] Such a standard would be consistent with SEC guidance. Indeed, in responding to AIMR's no-action request two years ago, the SEC specifically stated:

> You represent that under the AIMR standards, all fee-paying discretionary portfolios must be included in one or more of an adviser's composites. We note that the staff has taken the position that an adviser may choose to exclude from a composite certain similarly managed accounts, as long as doing so would not cause the composite performance to be misleading. [citation omitted]. SEC No-Action Letter to AIMR (pub. avail. Dec. 18, 1996).

Thus, the SEC no-action letter permitted but *did not require* mutual funds to be included in composites with separate accounts.

3. **Asset-Weighted Composites**

The GIPS proposal, like PPS, states that "[c]omposites must be asset-weighted…"[10] Both GIPS and PPS recommend that firms include equal-weighted returns for each composite as supplemental information.[11] We continue to believe that each firm should have the option of using either equal-weighted or asset-weighted composite returns. While there are differences between the two approaches, both methods convey valuable information about performance. Equal-weighted composites more fairly represent the central tendency of a manager's performance across all the accounts included in the composite and are particularly useful for presenting performance for many actively managed accounts. In contrast, the asset-weighted method focuses on the performance of dollars under management rather than accounts. Thus, equal-weighted composites may be more useful to individual investors as an indicator of individual portfolio performance. Asset-weighted composites may be more valuable to institutional investors. Indeed, our members - most of whom manage both institutional and high-net-worth assets - continue to inform us that they feel PPS is more targeted to the institutional, rather than high-net-worth, business. We believe that providing a choice on this key issue would convince more firms to use GIPS and/or PPS, thus increasing the standardization of fair and accurate performance reporting.

4. The Year 2000

The GIPS proposal sets January 1, 2000 as the date that (a) portfolios must be valued monthly; (b) firms must disclose the percentage of composite assets that are non-fee-paying portfolios; and (c) all presentations must state the currency used to express performance. AIMR has also proposed to incorporate these requirements into PPS on the same date.[12]

The investment adviser community currently is devoting substantial resources to reprogramming and redesigning computer hardware and software to ensure that services to clients are not interrupted on January 1, 2000. Congress, the SEC, and other regulators have placed the Year 2000 problem at the highest priority level and have emphasized to advisers the critical need to immediately devote resources to the issue.[13] Indeed, the SEC

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[10] GIPS Proposal, 2.A.4.

[11] *Id.* at 5.B.1(c).

[12] *See AIMR Performance Presentation Standards Implementation Committee Report*, Request for Public Comment (August 1998).

[13] *See, e.g.,* Investment Adviser Year 2000 Reports, Release No. IA-1769 (October 1, 1998); Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers, Release No. 33-7558 (July 29, 1998).

has issued a moratorium on implementing any new regulations that would require major computer reprogramming between June 1, 1999 and March 31, 2000. [14]

For many firms, AIMR's GIPS and PPS proposals would require computer software reprogramming and/or redesign by January 1, 2000. This timing would place a heavy burden on advisers' technology employees and consultants, who should remain focused on the more critical Year 2000 problem. Accordingly, we strongly encourage AIMR to delay the implementation of these proposals, preferably to January 1, 2001.

5. **Benchmarks**

The ICAA supports the concept of benchmarking and we applaud AIMR for its GIPS and PPS proposals to require disclosures of appropriate benchmarks.[15] As noted above, however, the ICAA supports one consistent set of standards. Accordingly, we suggest that the PPS proposal and the GIPS proposal regarding benchmarks be made consistent from the outset. For example, the PPS benchmark proposal states that if "the firm changes the benchmark that is used for a given composite in the performance presentation, the firm must disclose the reasons for the change." We support including such a statement in the benchmark provision of the GIPS proposal so that GIPS could accommodate a disclosed change if, for example, a better benchmark becomes available for a given composite, or the composition of a composite changes somewhat over time.[16] We also believe that the date of implementation of benchmark use should be the same for both GIPS and PPS, for the sake of clarity and consistency.

6. **Monthly and Daily Valuation**

The ICAA generally supports the monthly valuation requirement, subject to changing the implementation date, as noted above in item 4. The ICAA cannot support, however, the GIPS provision requiring daily valuations starting in 2010.[17] We submit that the costs, burden, and logistical difficulties of daily valuation far outweigh any marginal incremental benefits. Advisers do not always know when clients transfer assets into and out of accounts. Advisers are dependent on custodians, who are not subject to

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14 *See Policy Statement: Regulatory Moratorium to Facilitate the Year 2000 Conversion*, Release Nos. 33-7568, 34-40377, 35-26912, IA-1749, and IC-23416 (August 27, 1998).

15 *See AIMR Benchmarks and Performance Attribution Subcommittee Report*, Request for Public Comment (August 1998).

16 *See, e.g., Valicenti Advisory Services, Inc.*, Release No. IA-1774 (Nov. 18, 1998), suggesting that blended benchmarks must be readjusted periodically to match the changing compositions of balanced composites.

17 GIPS Proposal, 1.A.3, 2.A.2.

AIMR or SEC requirements, to provide accurate, prompt information.[18] Custodians, however, do not always provide information as promptly as desired and advisers need time to reconcile custodian statements with internal data and address any deviations. Moreover, certain products, such as fixed income products, would be very difficult to value daily. Other products, such as partnerships, may provide for differing valuation dates or requirements in their governing documents based on the structure of the vehicle.

We understand that the logistical burdens of daily valuation may decrease by the year 2010, potentially altering the cost-benefit analysis one way or the other. We see no need, however, to make that determination now by setting in stone the time frame for mandatory daily valuations. If, despite the current costs and difficulties, AIMR wishes to retain the concept of daily valuation in GIPS and PPS, we suggest that AIMR simply indicate a direction it wishes to move toward, with language such as "AIMR expects to consider" daily valuations starting in 2010.

7. Conflicts with Local Laws

GIPS quite properly requires that advisers comply with local or country-specific laws in cases of conflicts with GIPS. However, it is not clear how this meshes with the standard Compliance Statement indicating firmwide compliance with GIPS. We suggest that firms be able to state in such cases that "Firm has prepared and presented this report in compliance with GIPS, except to the extent that [X country's] law requires." The firm would then have to disclose where the conflict lies.

8. Interplay between PPS and GIPS during 1999 and after 2000

We fully support AIMR's goal of meshing PPS and GIPS so there will eventually be one consistent global standard. We believe that GIPS is drafted more clearly and flexibly in certain areas than PPS, and therefore urge AIMR to achieve one standard by phasing out PPS and incorporating the missing pieces into GIPS.

The transition period, however, presents problems that require clarification. For example, how should a global investment manager claim firmwide compliance? Can a global manager use PPS in the United States and GIPS in other countries? Or should such a manager arbitrarily select either PPS or GIPS and apply it to its entire business, both U.S. and foreign (also complying, of course, with any local laws that exceed or conflict with those standards)? We believe that the latter course is preferable and less confusing.

In addition, firms that wish to start complying with GIPS may have issues arise that are not addressed by GIPS but are addressed by PPS, such as wrap accounts and private placements. We suggest that AIMR explain somewhere in the GIPS proposal that it encourages or recommends the use of the PPS standards in those instances.

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18 Advisers are also dependent on pricing vendors, who may or may not price various equity or fixed income products daily.

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Assuming that the above concerns are addressed appropriately, the ICAA hopes to be able to endorse AIMR's GIPS proposal and to encourage our membership to comply with the new standards. The ICAA again commends AIMR and the GIPS Committee for their efforts toward achieving a global performance presentation standard. We look forward to working cooperatively with the GIPS Committee to further develop and refine the standards over time. We are willing to meet with AIMR staff and/or the GIPS Committee to discuss our common goal of one consistent global standard for performance presentation.

Please do not hesitate to call me if you have any questions or desire any further information.

Sincerely,

David G. Tittsworth
Executive Director

cc: Thomas A. Bowman, President and CEO, AIMR
Michael S. Caccese, General Counsel, AIMR
Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission
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