ICAA

Investment Counsel Association of America

2000 ICAA Comments & Statements

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Investment Counsel Association of America

2000 ICAA Comments & Statements

December 31, 2000

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January 12, 2000

VIA U.S. MAIL AND ELECTRONIC FILING

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Release Nos. 34-42009; IA-1845; File No. S7-25-99; Certain Broker-Dealers Deemed Not To Be Investment Advisers

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to provide these comments regarding the Commission's proposed rule that addresses the application of the Investment Advisers Act of 1940 (Advisers Act) to broker-dealers who offer their customers full service brokerage, including advice, for an asset-based fee instead of or in addition to traditional commissions, mark-ups, and mark-downs.[2]

The proposed rule involves important issues that require careful and serious deliberation. The heart of the rule, in effect, redefines statutory terms that have marked the legal distinctions between broker-dealers and investment advisers for several decades. The rule is particularly significant because it will provide guidance to the brokerage industry, the investment advisory profession, investors, and regulators concerning the circumstances and activities that will subject brokerage accounts to the laws and regulations governing investment advisers.

While the ICAA agrees that a rule is needed in this area, we are not convinced that the proposed rule gives appropriate and definitive guidance. The test employs three concepts: (1) the exercise of investment discretion (2) which is "solely incidental" to the broker's primary business; and (3) the broker employs a disclaimer in advertising. With respect to the first concept, we believe that if an account bears the fundamental characteristics of an advisory account – or if it is marketed as such – it should be subject

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[1] The ICAA is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 250 investment advisory firms that collectively manage in excess of $2 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[2] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 34-42099; IA-1845, November 4, 1999 (Release).

to the provisions of the Advisers Act. These fundamental characteristics include more than discretion. With respect to the second concept, the Commission does not provide adequate guidance regarding the meaning of "solely incidental," but at a minimum it cannot include discretionary services. Finally, the brief advertising disclaimer proposed in the rule would not achieve its intended goal of reducing confusion among investors.

Accordingly, the Commission should reconsider whether the recommended approach is workable, suitable, and consistent with relevant statutory provisions and with the realities of the marketplace. If, however, the Commission decides to pursue its current approach, we respectfully request that it consider the following issues before adopting any final rule.

Summary of ICAA Comments

1. Despite dramatic changes that are occurring in financial services, fundamental differences remain that distinguish core investment advisory functions from core brokerage activities, including the fact that investment advisers owe a strict fiduciary duty to their clients.
2. The ICAA agrees with the Commission that a functional test focusing on the nature of services provided (rather than the form of the broker-dealer's compensation) is appropriate in determining whether and under what circumstances a brokerage account may be excluded from provisions of the Advisers Act.
3. The functional test proposed by the Commission should be modified as follows:
   - The rule should treat discretionary brokerage accounts that charge commissions in the same manner that it treats discretionary brokerage accounts that are fee-based.
   - The rule should clarify that an account that receives discretionary advisory services is by definition not "solely incidental" to a broker-dealer's business.
   - The rule should prohibit broker-dealers from advertising advisory services that are "solely incidental" to the conduct of the broker's primary business. Alternatively, the rule should require more meaningful disclosure in advertisements and any other materials that market advisory services of broker-dealers – and in contracts and agreements governing such accounts – in order to inform consumers of the significant differences between advisory and brokerage accounts, functions, and legal responsibilities.
4. The Commission should preserve the fundamental differences between brokerage and advisory services if and when it considers rules under or amendments to section 206(3) of the Advisers Act (prohibiting principal trades by investment advisers absent specific disclosure and client consent).

Background

We commend the Commission for issuing the proposed rule. It has been evident for some time that broker-dealers have been migrating toward asset-based fees. We are convinced that the primary reason for this trend is increased competition in execution services, primarily from the proliferation of electronic communications networks (ECNs) and other Internet-based entities that offer execution services at a fraction of traditional full service brokerage costs. As commissions are being squeezed – and as the number of investors and assets continues to grow – many full service brokers have begun to diversify their products and services by offering on-line trading, asset-based fees, various advisory programs, and other additions to their traditional programs in an effort to respond to competitive forces and to capitalize on the major influx of assets from a new generation of investors.

As the Commission notes in its proposed rule,[3] these new brokerage programs involve the receipt by broker-dealers of "special compensation," as set forth in the Advisers Act. Receipt of special compensation has meant – up until the proposed rule was released – that a broker-dealer could not claim an exclusion from provisions of the Advisers Act. The fact that fee-based brokerage programs have proliferated contrary to specific statutory provisions of the Advisers Act is clearly an undesirable regulatory result. There is an obvious need for the Commission to provide explicit guidance to broker-dealers, investment advisers and, most importantly, to investors, as to where the distinguishing lines between brokerage and advisory services will be drawn and how they will be enforced in the future.

The need for explicit guidance is even more compelling when considering the growth of high profile advertising touting the virtues of broker-sponsored fee-based programs and advisory services. During the past several months alone, full service brokers have spent millions of dollars on campaigns designed to attract consumers to their new programs, including commercials that emphasize advisory services and the merits of asset-based compensation. Given the prominence of these efforts, it is incumbent upon the Commission to take prompt and decisive action that will benefit investors by helping them understand the types of services that are available and the differences between brokerage and advisory services.

Fundamental Differences Separate Advisers and Brokers

There are fundamental differences between most investment advisers and most broker-dealers. Broker-dealers execute trades while advisers do not. Broker-dealers typically have custody of client assets while most advisers do not. In street parlance, brokers are the "sell" side while advisers are the "buy" side. Broker-dealers traditionally have employed sales forces compensated primarily by commissions while most advisers have not. Broker-dealers are interconnected to each other and to other financial service providers in ways that many advisers are not and thus present greater risks to investors and the markets when problems arise.[4] And, as emphasized in the proposed rule, most broker-dealers do not exercise discretionary authority over client accounts, unlike most SEC-registered investment advisers.

[3] Release, p. 7: "Fee-based compensation may constitute special compensation under the Act because it involves the receipt by a broker of compensation other than traditional brokerage commissions."

[4] The Commission recognized this fact in its treatment of Year 2000 issues. "Year 2000 problems could have negative repercussions throughout the world's financial systems because of the extensive interrelationship and information sharing between U.S. broker-dealers and foreign financial firms and markets." *Reports To Be Made By Certain Brokers and Dealers*, Rel. No. 34-39724 (March 5, 1998).

There also are fundamental differences between the laws and regulations governing broker-dealers and investment advisers. Most important from an investor's point of view, investment advisers are subject to a strict fiduciary duty.[5] In a 1978 release, the Commission noted that the protections afforded investors under provisions of the Securities Exchange Act of 1934 "may not be so broad as those afforded under the comparable provisions in Section 206 of the Advisers Act" and that such differences "are appropriately related to the obligations of persons required to be registered under the Advisers Act."[6] In the same vein, the SEC's 1980 Inspection Manual states that: "An investment adviser is a fiduciary who owes his clients undivided loyalty, and is prohibited from engaging in activity in conflict with the interest of any client."[7] Broker-dealers, on the other hand, generally are subject to the standard of suitability in making investment recommendations and are subject to regulation by both the Commission and the National Association of Securities Dealers. Investment advisers are primarily regulated by the Commission (advisers with less than $25 million in assets under management are regulated exclusively by the states). As described in the Commission's 1978 release, the bottom line is that "the Advisers Act provides individuals with certain protections not available under the Exchange Act."[8]

The ICAA recognizes the leadership role Chairman Levitt has played during the past several years in urging the broker-dealer industry to reform its compensation practices. We commend Chairman Levitt's longstanding efforts to "accelerate efforts to reduce or eliminate conflicts of interest between brokers and their clients."[9] The ICAA shares these concerns. Since our organization was founded in 1937, the ICAA has recognized the potential conflicts of interest that may arise when commissions are charged. Since 1937, our recommended standards have always emphasized the importance of fee-based compensation in rendering advisory services.[10] Thus, we understand the benefits to investors of fee-based compensation. While such compensation eliminates some conflicts of interest, it also may create new conflicts,

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[5] *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963); *In re Arlen Hughes*, Exchange Act Release No. 4048 (February 18, 1948).
[6] *Final Extension of Temporary Exemption from the Investment Advisers Act for Certain Brokers and Dealers*, Investment Advisers Act of 1940 Rel. No. 626; Securities Exchange Act of 1934 Rel. No. 14714 (April 27, 1978). The release also notes that "[a]nother reason some broker-dealers have given for desiring an exemption from the Advisers Act is their belief that an investment adviser, as such, may be held to have higher duties to his clients than does a broker or dealer to his customers."
[7] *Regulation of Investment Advisers*, Lemke and Lins, App. F7 at 23 (1999).
[8] Id., note 6.
[9] *"The State of the Brokerage Profession,"* Remarks by Arthur Levitt to the Securities Industry Association (April 20, 1998).
[10] The ICAA's standards regarding compensation have remained virtually unchanged for more than 60 years. In 1937, Section III of the ICAA's *Code of Professional Practice* provided that: "Compensation of an investment counsel firm should consist exclusively of direct charges to clients for services rendered, and should not be contingent upon profits, upon the number or value of transactions executed, nor upon the maintenance of any minimum income." Today, Section IV of the ICAA's *Standards of Practice* provides that: "Compensation of a member firm for investment advisory services should consist exclusively of direct charges to clients for services rendered and should not be contingent upon the number or value of transactions executed."

which are addressed principally by the Advisers Act (not the Exchange Act).[11] Although fee-based compensation reduces the incentive to churn an account to generate commissions, it is not in and of itself an inherent guarantee that such fees are reasonable or that other services connected with such a fee are in the client's best interests.[12]

It is understandable that many full service brokers are anxious for the Commission to adopt the proposed rule in order to ensure that their fee-based accounts are not "re-designated" as advisory accounts. Stated differently, the brokerage community would not have urged the Commission to issue the proposed rule were it not for the fact that there are substantial differences in the manner in which investment advisers and broker-dealers are regulated.

There are at least four aspects of the Advisers Act and accompanying laws governing the conduct of investment advisers that are significantly different from those applicable to broker-dealers. First, as noted above, advisers owe a strict fiduciary duty to each of their clients that goes well beyond any similar legal obligation of broker-dealers.

Second, section 206(3) of the Advisers Act prohibits an investment adviser from selling or purchasing any security to or from a client when acting as a principal for its own account, unless each such transaction is disclosed in writing to the client and the client consents to it.[13] Many broker-dealers have an existing inventory of securities and thus they have a natural incentive to buy and sell such securities to and from clients on a principal basis.

Third, the Advisers Act requires investment advisers to make certain disclosures that differ substantially in timing and content from current disclosures required by broker-dealers. These include requirements to deliver an informational brochure promptly and to make disclosures about an investment adviser's potential conflicts of interests, other business and activities and affiliations, disciplinary history, employees' educational and professional background, and, in some cases, financial condition.[14]

Finally, whether or not desirable from a policy perspective, the Advisers Act flatly prohibits testimonials and past specific recommendations in advertising. Brokers frequently employ testimonials in advertising and such use appears to be increasing.

In issuing the proposed rule, we are confident the Commission has no intention of diluting the unique investor protections or specific statutory provisions of the Advisers Act. We also are confident the Commission does not wish to allow broker-dealers to avoid such protections or provisions when performing advisory services that go beyond those described in section 202(a)(11)(C) of the Advisers Act. Finally, we are confident the Commission does not want to open the door and allow broker-dealers that claim an

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[11] For example, the Advisers Act applies restrictions to aspects of asset-based compensation that may pose certain conflicts. *See, e.g.,* Section 205 of the Advisers Act.

[12] *See, e.g., "Merrill: Schwab jab a shot in the dark," Investment News*, p.1 (November 8, 1999).

[13] Many observers believe that the disclosure and consent requirements of section 206(3) operate as a *de facto* prohibition on so-called principal transactions by investment advisers.

[14] *See* Release, fn. 6.

exclusion from the Advisers Act to market advisory services in a manner that may mislead investors.

The Commission's Proposed Functional Test Should Be Modified

The proposed rule purports to adopt a functional test that focuses on the nature of services provided rather than the form of compensation.[15] Under the proposed test, the Commission would first examine whether advisory services are provided on a discretionary basis instead of looking to the form of compensation. A broker-dealer would be able to claim an exclusion from the Advisers Act as long as: (1) the advice is provided on a non-discretionary basis; (2) the advice is solely incidental to the brokerage services; *and* (3) the broker-dealer discloses to its customers that their accounts are brokerage accounts.

We agree that a functional test that focuses on the nature of services provided should be employed in making the determination as to whether a brokerage account falls within the provisions of the Advisers Act. Functional regulation is consistent with the SEC's position in the recent financial services modernization debate[16] and is consistent with the SEC's treatment of wrap fee accounts in the release.[17] We also agree that examining whether advisory services are provided on a non-discretionary or discretionary basis is an important factor to consider in determining whether an account is subject to the Advisers Act.[18] However, we believe the proposed rule needs to be modified in certain respects to ensure that investors are not misled or confused.

Commission-Based Discretionary Accounts

Perhaps the most glaring inconsistency in the proposed rule is the statement that discretionary brokerage accounts that charge commissions will be treated differently from discretionary brokerage accounts that charge fee-based compensation.[19] At a minimum,

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[15] "The proposed rule makes the nature of services provided, rather than the form of compensation, the primary factor in determining whether the Adviser Act applies." *SEC Press Release No. 99-147* (November 5, 1999).

[16] *See, e.g.,* Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization and H.R. 10, the Financial Services Competition Act of 1997, before the House Committee on Commerce, Subcommittee on Financial and Hazardous Materials (July 17, 1997) ("For more than a decade, the Commission has urged Congress to adopt a system of functional regulation for all participants in the securities markets. The Commission believes that the same rules should apply to the same activities in the financial marketplace – particularly when the rules are designed to protect investors. The Commission continues strongly to support the principle of functional regulation.").

[17] Release, p. 12.

[18] Advisory services plainly encompass far more than managing discretionary accounts, as reflected in the SEC's and states' definitions of "investment adviser" and in the SEC's Schedule I description of "continuous and regular supervisory or management services." We recognize, however, that the concept of discretion has some bright line utility as a functional test for the purpose of deciding whether accounts serviced by brokers are subject to the Advisers Act.

[19] Release, p. 10. "Under the statute, however, discretionary accounts from which a broker-dealer does not receive special compensation, *e.g.*, accounts that pay commissions, would still be treated as brokerage accounts not subject to the [Advisers] Act. *In this respect, a regulatory distinction would continue to be drawn based solely on the pricing of an advisory service*." (emphasis added)

if the Commission adopts a functional test that replaces the form of compensation with the type of discretion exercised over the account, the rule should be applied consistently.[20] Providing an *exception* for discretionary commission-paying brokerage accounts from the *exclusion* for broker-dealers that charge asset-based fees for discretionary advisory services is confusing and unwarranted. No rationale is suggested in the proposed rule for making such an exception. In light of the fact that the Commission is proposing to overturn 60 years of history by essentially eliminating the concept of "special compensation" from the law, we do not believe that providing an exception for discretionary commission-paying accounts can be justified. To permit such a distinction trivializes the substantial services provided by investment advisers to discretionary accounts – services that should not vary when commissions are charged. Further, as discussed below, discretionary accounts by definition cannot be "solely incidental" to execution services. We respectfully suggest that the Commission assess the proposed exception to the exclusion from the viewpoint of an investor and strongly urge the Commission to remove this inconsistent and unnecessary anomaly from the proposed rule.

The "Solely Incidental" Prong of the Test

We also urge the Commission to take this opportunity to provide better guidance as to what "solely incidental" means in section 202(a)(11)(C) of the Advisers Act. Our review of no-action letters and other SEC releases on the subject indicates there is little meaningful guidance on the subject of what "solely incidental" means. The plain meaning of the term is clear – activities that are a *minor* part of the broker's business. The inclusion of the word "solely" further clarifies Congress' intent and underscores the conclusion that a broker-dealer could rely on this part of the law if its advisory services are *only* a relatively unimportant or insignificant part of its business.

We believe that a brokerage account that receives discretionary services is *by definition* precluded from being an account that may claim an exclusion under the Advisers Act under the "solely incidental" test. When a broker-dealer has discretionary authority over an account, it is difficult to argue that such advisory services are merely "incidental" to that account. A broker-dealer with discretionary authority has the ability to pick and choose securities to buy and sell on behalf of an account without obtaining the investor's consent. *Discretionary authority represents a highly intensive form of rendering investment advisory services and thus cannot be characterized as something that is simply an "incidental" consideration for an account or an investor.*

[20] Interestingly, ERISA employs a functional test for determining whether authority can be delegated to a "fiduciary." A "fiduciary" must have discretionary control and, to achieve a full delegation, the plan sponsor must have written acknowledgement from the adviser that it is an "investment manager" and a "fiduciary." *See* sections 321, 402, and 405 of ERISA.

Advertising Requirements

Finally, we strongly urge that the rule prohibit a broker-dealer from marketing accounts based on the advisory services provided if the broker-dealer also claims an exclusion from the Advisers Act under section 202(a)(11)(C).[21] The need for such a prohibition is clear – to protect investors from being misled. In the proposed rule, the Commission notes that broker-dealers offering fee-based advisory services have heavily marketed them and that this "raises troubling questions as to whether the advisory services are not (or will be perceived by investors not to be) incidental to the brokerage services."[22] If the fee-based advisory services are "solely incidental" within the meaning of the statute, the prohibition on marketing such accounts could not – by definition – have a significant impact on the broker-dealer's business.[23]

More importantly, such a prohibition is necessary for the protection of investors. It is patently misleading for a broker-dealer to market its advisory services *when in fact such services are only an insignificant part of the broker's business and the broker is claiming an exclusion from protections provided to investors under the Advisers Act*. An investor who responds to such marketing materials would have a reasonable expectation that the entity marketing such services is subject to the protections afforded investors under the Advisers Act.[24]

If the Commission nevertheless pursues the proposed disclosure alternative, it must require more meaningful and appropriate disclosure. The rule should require broker-dealers to include prominent plain English disclosures in any marketing efforts to apprise investors that the advisory services being offered are not subject to protections and provisions of the Advisers Act, including the fiduciary responsibility that a registered investment adviser owes to its clients. While the Commission may determine the appropriateness of any such disclosure on a case-by-case basis,[25] we suggest that a prominent disclosure along the lines of the following could be appropriate in marketing materials relating to advisory services provided by a broker-dealer that claims an exclusion from the Advisers Act:[26]

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[21] Release, p. 11 ("Comment is requested as to whether, instead of the proposed disclosure, we should preclude brokers from relying on the rule if they market these accounts in such a way as to suggest they are advisory accounts").
[22] Release, p. 11.
[23] This problem also manifests itself in enforcement; for example, for how many seconds will the SEC require a disclaimer to appear on a television screen to deem it sufficiently "prominent."
[24] *See Wall Street Journal*, pp. B2-B3 (December 15, 1999). On one side of the two-page advertisement is the following quotation and citation: "For some investors, particularly those with large or complex portfolios who want on-going investment management, the services of a fee-compensated financial advisor may be appropriate. - Leading Discount Broker's Investment Tip #3." On the other page, the word "Amen" appears, followed by the broker-dealer's name, telephone number, and Internet address. We think it is reasonable to conclude that an investor responding to such an advertisement is seeking ongoing and continuous fee-based portfolio management services, not brokerage services.
[25] The relative prominence of the services advertised should be an important factor in assessing disclosure.
[26] Appropriate disclosure also should be included in any contracts or other written agreements pertaining to advisory services provided by a broker-dealer that claims an exclusion under section 202(a)(11)(C) of the Advisers Act.

> [Name of broker-dealer] is a registered broker-dealer. Our primary business is executing securities transactions. The accounts and services described are *not* subject to the Investment Advisers Act of 1940 (Advisers Act) and Advisers Act rules because we believe that any advisory services we provide are solely incidental to our primary business as a broker-dealer. As such, [name of broker-dealer] is not required to comply with investor protections provided under the Advisers Act, including the fiduciary responsibility an investment adviser owes to its clients.

Absent such prominent disclosure, investors likely will be misled as to the legal status of the broker-dealer and its obligations under law. The recommended disclosure will provide investors with relevant and accurate information regarding the advisory services offered by the broker-dealer and will enable investors to make a better and more informed decision about such services.

The ICAA Agrees with the Proposed Assets Under Management Test

The Commission proposes to amend Schedule I of Form ADV to confirm that broker-dealers may include in their calculation of assets under management only the value of accounts over which they exercise investment discretion. The ICAA concurs with this approach. Accounts that brokers claim do not meet the functional definition of advisory accounts cannot be deemed to receive "continuous and regular supervisory or management services" for purposes of investment adviser registration requirements.

Changes to the Principal Trading Prohibition Must Be Considered Carefully

As noted above, one of the primary differences between broker-dealers and investment advisers is the restriction on principal trading that applies to investment advisers.[27] No comparable provision exists in the Exchange Act or other laws or regulations governing broker-dealers. Congress included section 206(3) in the original Advisers Act due to its concerns about potential overreaching by advisers at the expense of their clients. As such, section 206(3) represents one of the major differences between advisers and broker-dealers and the laws and regulations governing each.

The broker-dealer industry clearly supports efforts to revise the current prohibition. For example, legislative changes were submitted to the Congress last year by the broker-dealer community that, among other things, would amend section 206(3) of the Advisers Act to allow principal trades and agency cross transactions by an investment adviser under much broader circumstances than the law currently allows.

[27] Section 206(3) of the Advisers Act provides that: "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transactions."

Earlier this year, Chairman Levitt stated that the Commission will consider changes to the rules under section 206(3):

> Under the Advisers Act, an investment adviser must obtain the client's consent before selling him or her securities out of the inventory of an affiliated broker-dealer. But getting the explicit consent to do so can delay a transaction unreasonably. Many traditional brokerages do business over the phone and it can be quite cumbersome to secure timely consent. So, transactions that could have been good for the client and the firm may never take place because people just don't want to bother.
>
> Given the changing structure of our markets and the corollary effects it is having on our business, I believe this is the right time to consider whether it might be appropriate to provide an exemption from the restrictions on principal trading. While we want to open new opportunities to firms and their customers, there are real risks to allowing principal trading in certain situations – such as in illiquid securities or large, market-moving orders where it is very difficult to know whether the client paid a fair price. *While we want to make it easier for firms to get paid for their advice* as well as their executions, we will not simply exchange one potential conflict of interest for another.
>
> The Division of Investment Management will develop amendments to the rule that strike a balance between these two concerns. I believe we can do this without sacrificing the interests of the profession or investors.[28]

The SEC's recently published semi-annual regulatory agenda indicates that a rulemaking on this matter will be issued in the very near future.[29]

The ICAA obviously cannot anticipate what the Commission may propose in this area, but will review any such rulemaking carefully, if and when it is issued, and will respond accordingly. However, the possibility of the SEC granting a new exemption under section 206(3) – when combined with the proposed rule that gives broker-dealers increased latitude to avoid the protections of the Advisers Act – raises concerns of a "slippery slope" whereby the statutory distinctions between brokerage activities and advisory services are eroded – or even eliminated – by a series of rulings or actions by the Commission.

We trust the Commission will consider the long-term and cumulative implications of these and related issues to ensure that investor protections of the Advisers Act are

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[28] *Remarks Before the Securities Industry Association's Legal and Compliance Seminar* (April 13, 1999)(emphasis added).

[29] *Semi-Annual Regulatory Agenda*, 64 Fed.Reg. at 65512 (November 22, 1999). "The staff of the Division of Investment Management is considering recommending that the Commission revise the conditions under which investment advisers may enter into principal transactions with their clients."

preserved and that such protections will not be circumvented by broker-dealers or other financial service providers that offer, market, or provide investment advisory services.

Conclusions

The ICAA commends the Commission for considering these important issues. The trend toward asset-based fees for advisory services by broker-dealers clearly conflicts with existing statutory provisions and interpretations thereof and this conflict needs to be addressed and resolved. We believe the interests of investors and of the regulated community will best be served by a functional test that focuses on the nature of services provided and/or marketed, while recognizing and preserving the fundamental differences between brokerage activities and advisory services.

While discretion is an important consideration in making this determination, we believe, at a minimum, that the proposed rule requires the following modifications: (a) the rule should be applied consistently (*i.e.*, discretionary brokerage accounts, *whatever the form of compensation*, should be subject to the protections of the Advisers Act); (b) the rule should clarify that an account that receives discretionary advisory services is by definition an advisory account that is not "solely incidental" to a broker-dealer's business and thus cannot enjoy an exclusion from the Advisers Act; and (c) the rule should prohibit broker-dealers from marketing advisory services that are "solely incidental."

The Commission has recognized that certain provisions of the Advisers Act provide unique protections to investors. In fashioning a rule that will have profound and lasting consequences on whether these investor protections are applied – or avoided – we trust the Commission will give appropriate weight to statutory provisions that define the fundamental distinctions between broker-dealers and investment advisers.

We would be pleased to work with the Commission's staff in drafting language to modify appropriately the proposed rule. Please do not hesitate to contact us if we may provide additional information or clarification to the Commission regarding any of these matters.

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 Unger
Paul F. Roye, Esq.

TESTIMONY OF MARK F. KEMPER ON BEHALF OF THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.

Before the Department of Labor
Hearing on Cross-Trades of Securities
By Investment Managers

February 10, 2000

SUMMARY OF TESTIMONY

1. *Benefits of Cross Trading*. Cross-trading between actively managed accounts eliminates the transaction costs ordinarily incurred in trading securities for each account in the open market. This cost reduction is in the best interests of both clients. Because the benefits of cross-trading are so apparent, institutional clients often request that managers have internal crossing capabilities. Plan fiduciaries are capable of and should have the option of deciding whether a plan should participate in cross trading opportunities.

2. *Potential Abuses in Light of Opportunities to Cross Trade*. The Department has identified two concerns regarding potential abuse in a cross-trading program: the trade may be unfairly priced to favor one party and the opportunity to cross-trade may drive a decision to purchase or sell a particular security. We have more than adequately addressed these concerns. First, appropriate pricing mechanisms would ensure a fair and objective price in a cross-trade transaction. Second, the various scenarios under which cross-trading opportunities arise do not permit cross-trading to drive the investment decision.

3. *Inherent Safeguards*. In addition, currently existing laws and regulations provide significant protections to investors against any cross-trading impropriety. These current safeguards will serve to deter and prevent any potential abuses. Moreover, an inherent protection against any potential impropriety is the motivation of investment managers to achieve high performance for all of their accounts. All accounts generally are reflected in performance composites and managers have no incentive to negatively affect performance.

4. *Exemption Safeguards*. A number of additional conditions and safeguards similar to those already in analogous Department exemptions and SEC regulations would provide yet another layer of protection for investors. A class exemption containing objective pricing procedures, full disclosure to and consent of clients, record-keeping, and other conditions would prevent any potential improprieties while permitting pension plan clients to enjoy the benefits of cross-trading that other clients currently possess. We urge the Department to proceed in drafting a class exemption for cross-trades among actively managed accounts and are willing to work with the Department in that regard.

INTRODUCTION

The Investment Counsel Association of America is a national not-for-profit association that represents the interests of SEC-registered investment advisers, that is, advisers that have more than $25 million under management. Founded in 1937, the Association's membership today consists of more than 250 investment advisory firms that collectively manage funds in excess of $2 trillion for a wide variety of individual and institutional clients, including pension plans.

We welcome the opportunity to testify at the Department's hearing on cross-trade transactions. The issue of cross-trade transactions for actively managed pension plans is of high importance to ICAA members. As you know, the ICAA submitted a lengthy and detailed letter to the Department dated May 19, 1998 in response to the Department's request for comments on cross-trades in March of 1998. We appreciate the opportunity to provide further information today.

OPENING REMARKS

The members of the ICAA urge the Department to issue a class exemption that permits investment managers who employ active management styles to trade securities between their managed accounts and funds. We feel strongly that the benefit of allowing ERISA covered plans to participate in such cross-trading activity far outweighs any potential risks in doing so. We are also confident that a class exemption permitting active managers to cross trade could be crafted with sufficient safeguards which, when coupled with existing laws, would adequately protect covered plans from any potential abuses that the Department perceives cross trading may present.

BENEFITS OF CROSS TRADING

The benefit of cross trading is that it eliminates the transaction costs that are normally incurred in trading securities in the open market. As you know, transaction costs consist of two primary components: commissions or spreads on the one hand and market impact on the other. We doubt that anyone in the Department disagrees with the proposition that the commission savings which would result from cross trading would be a significant benefit to covered plans. However, we are also aware that the Department has expressed concerns over whether the avoidance of market impact would truly be a benefit to covered plans.

We have two thoughts in this regard: The first is that it is the opinion of our members that avoiding market impact would generally benefit covered plans. Our members also wish to make the Department aware that a number of their ERISA clients have expressed to them similar opinions. Indeed, news accounts of a recent court action brought by a pension plan against an adviser seem to indicate that the plan wanted the adviser to minimize market impact rather than unload the securities altogether in the market.

Market impact is short-term price volatility caused by trading activity. The primary market participants positioned to profit from this short-term price volatility are the broker/dealers and day traders. Covered plans, on the other hand, generally are long-term, buy-and-hold investors. When viewed from a long-term investment horizon, market impact will generally even out and not be a significant factor in the long-term performance of a security. Nevertheless, market impact is a transaction cost which, if avoided, may reduce covered plans' costs of investing over time with respect to its overall portfolio.

The Department's concern with respect to avoiding market impact is that it may not be in the best interests of the client who would profit from the market impact. We believe that this concern ignores the fact that in any potential cross trading situation the manager has a duty to balance the interests of both the buyers and sellers involved. The crossing opportunity investment managers are faced with is the situation where they need or want to buy a security for one client and sell the same security for another. Absent the ability to cross trade, the manager could favor either the buyer or the seller. To favor the seller, the manager would enter the buy orders into the market, driving the price up, and then begin executing the sales. If the manager started with the sales first, depressing the price, and then began working the buys, it would favor the buyer. However, in order to satisfy its fiduciary duty to each client, the manager has to work the buys and sales at the same time using its best efforts to minimize market impact which could favor one client over the other. This process could be lengthy, potentially exposing both clients to market risk contrary to the investment decision made for each client. Unquestionably, the best way to balance these interests is cross trading, which allows both clients to execute at the current market price, unaffected by trading activity.

Our second point on market impact relates to general standards of fiduciary obligations. One of the most prudent things Congress and the Department have done in their respective roles with respect to ERISA is to never have legislated or regulated what types of investments or investment techniques are prudent. These decisions have been left to the individual fiduciaries of covered plans who are required to act in accordance with the ERISA fiduciary standards, including a strict standard of care. We believe the Department should treat the question of market impact similarly. *The Department should issue a cross-trading exemption that requires an investment manager who wishes to engage in cross trading to provide each client with a copy of its detailed procedures for effecting cross trades and to require an independent plan fiduciary to give its written consent before cross trades may be effected on its behalf.* This would allow those fiduciaries, whose duty it is to maximize investment returns for covered plans, to make the fiduciary decision as to whether the benefit of cross trading outweighs the risks, or vice versa.

Plan fiduciaries are capable of and currently make similar decisions on a regular basis. Among other things, they regularly make decisions on whether to direct plan brokerage, whether to allow managers to engage in soft dollar trading, and whether to permit managers to effect trades with their affiliated brokers. It has been my experience with affiliated brokerage, which presents issues similar to those raised by cross trading, that some 60-70% of the plan fiduciaries agree to allow us to trade with an affiliated broker and are willing to monitor our activity in this regard. The other 30- 40% of plan fiduciaries believe the risks outweigh the benefits and/or do not want to monitor a manager’s affiliated trading activity and, consequently, withhold their consent. We believe that plan fiduciaries would be capable of making similar decisions with respect to cross trading and should have the opportunity to do so.

POTENTIAL ABUSES IN LIGHT OF OPPORTUNITIES TO CROSS TRADE

In order to design effective safeguards for a cross-trade class exemption, we first have to understand the types of potential abuses crossing is perceived to present and the situations under which crossing opportunities arise. The main perceived abuse is the ability for an investment manager to trade a security between two accounts at a price that is above or below its current market value. The limited cases of past abuses of which I am aware fall into this type of violation of fiduciary duty. However, the Department has also expressed concern that cross trading could facilitate an investment manager's trading what I will call the "wrong security" from one account to another. By using the term the "wrong security," I mean a security that an investment manager believes will go down in price (or up if trying to favor the buyer). I also include in this definition a security that a manager crosses into an account solely because of the cross-trading opportunity and not because of the individual merits of the security.

The circumstances under which crossing opportunities arise are slightly different for active managers depending on how the firm manages money. At my firm, all accounts are managed pursuant to model portfolios. The models are actively managed which means we have the discretion to change them as we deem necessary. All client portfolios having similar objectives and guidelines are managed to the same model portfolio and hold the same securities in the same weights as all other clients being managed to that model. Many firms manage money in this fashion, but many firms also manage money through individual portfolio managers. Individual portfolio managers do not follow models for all of their clients but rather have the discretion to alter the composition of each account under their control, subject to compliance with client guidelines. However, even accounts managed by individual portfolio managers often have considerable overlap in the securities they hold. For all types of accounts, the opportunity to cross trade arises when (1) accounts are liquidating; (2) accounts are funding or a model changes; (3) a security's attributes change; or (4) a client changes its guidelines.

(1) Liquidating Accounts: The event that gives rise to the most cross-trading opportunities by far for all management styles is when an account is liquidating. It is important to distinguish between a liquidating account and a terminating account. When a separate account client fires an investment manager wholly or partially, the client always has the right to keep the securities that are held in its account. This serves as another important safeguard since the client ultimately controls the decision of whether the securities could be cross traded. Only when a manager has been fired and the client has asked the manager to sell the securities in its account does a cross-trading opportunity arise. A liquidating account is a triggering event that allows the investment manager to purchase the securities being sold on behalf of its existing clients or new clients whose fundings coincide with the liquidation. Most likely, the manager holds the same security in other accounts and believes that it is a good investment and, generally, a manager would have no incentive to favor a client who is terminating or reducing its relationship with the manager. As such, the manager would not buy a security from a liquidating account into a client account that is staying under its management – unless it felt the security was a prudent purchase.

The primary potential for abuse under the liquidating account scenario is if the manager were able to buy the securities below their current market value in order to benefit continuing accounts at the expense of the liquidating account. As I will discuss later, adequate pricing protections to avoid this type of abuse can easily be built into any cross-trade class exemption the Department should issue. In addition, a client liquidating an account is likely to monitor the manager's activities closely and will spot any irregularities. Consequently, although we strongly believe the Department should issue a broad cross-trading exemption for active managers, an exemption should at very least include the liquidating account scenario.

When a covered plan is liquidating its investment in a pooled fund, the plan may be able to request a redemption of securities in-kind, but it is generally within the discretion of the fund fiduciaries whether to distribute in cash or in-kind. Although it is the fund manager, not the investor, who would be selling the individual securities and potentially engaging in a cross trade, the fund is in a liquidating account situation whenever a client has made a redemption request. Thus, the same considerations that apply to separate accounts should apply to pooled funds as well. In other words, once the client has made the decision to sell certain securities, the manager no longer has discretion with respect to the sales decision that would expose it to conflicting loyalties of the type the Department presumably has concerns.

(2) Funding Accounts: Another scenario giving rise to cross-trading opportunities is when new fundings occur, without a contemporaneous liquidation. The manager, who must now invest the cash derived from the new client, can either effect trades in the open market or purchase securities from its existing accounts. Looking first at managers who use models, the manager's other clients would have no securities to sell to the new account unless the manager changed its model at the same time by reducing the weightings on one or more names in the model. Note that if the manager eliminated an issue from the model, which it would do if it were a “wrong” security, this would not give rise to a crossing opportunity because the eliminated name could not be bought into the new account and remain in line with the model. This fact would prevent the manager from purchasing a “wrong” security for the new account.

However, we are aware that the Department has included in its current cross-trade proposal for model-driven accounts, a 10-day waiting period after a model change, during which crosses cannot be effected. Not only do we believe that such a restriction is unnecessary for model-driven strategies, we believe any similar restriction would not be needed in an active cross-trading exemption. In addition to the reasons just given, we believe such a restriction is unnecessary because managers simply do not alter their models on a trade-by-trade basis, but rather on a security–by-security basis. Any change in the model would necessarily affect all of the manager’s clients using that particular model. This means that if a manager changed its model in order create a cross-trade opportunity to favor one client, he would be doing so at the detriment to all of his other clients. As a result, we believe that a model change should be considered a triggering event allowing a manager to cross trade on behalf of all accounts affected by the change.

For instance, at my firm we use a valuation module to determine what we believe to be the true value of a stock. We purchase those stocks whose current market value is below what we perceive to be its fair value. If we determine that the fair value of ABC company’s stock is $20, but the current market value is $10, we may give that stock a portfolio weighting of 5% which means that all clients managed to that model will have 5% of their accounts invested in ABC company stock. If the price of ABC stock goes up to $15, we would still want to hold the stock but would probably cut the weighting back to 2.5%. If this model change coincides with a new funding we would want to cross trade to minimize transaction costs for all clients involved. Currently, since we are not allowed to cross trade, we have to execute all the trades in the open market and pay full commissions.

For investment management firms using individual portfolio managers, similar opportunities to cross trade present themselves when a new client comes in or an existing client adds funds to an existing account. A prohibition on cross trading on behalf of accounts the manager would have an incentive to favor (such as proprietary accounts) would effectively control the potential abuses raised by crossing opportunities that arise under this management style. The manager would have no reason to disfavor any particular client account under his control, and the other portfolio managers in the firm would not likely agree to purchase a "wrong" security for an account under their control because of the negative effect it would have on their performance track record. The implementation of pricing protections would provide further safeguards.

(3) Security Changes: Another scenario giving rise to any significant cross trading opportunities is when a particular security's attributes change. For instance, when a bond rating changes, when a stock changes from a small to an intermediate capitalization stock, or when a company changes as a result of a merger, are all situations which could give rise to a crossing opportunity. In addition, market movements that cause the relative weighting of a security in a portfolio to exceed acceptable ranges can require trades to be effected to keep an account in line with the guidelines or model. As with account liquidations and new fundings, a change in the attributes of a security and the need to trade to bring an account back in line with a model are common cross-trade opportunities that are beyond the ability of the manager to control.

(4) Guideline Changes: The last common scenario that presents a cross-trading opportunity is when the client initiates a change in its investment guidelines. The client may wish to sell a certain type of security (for example to change its allocation) that the adviser feels is appropriate to buy for a different client. Currently, accounts that are not governed by ERISA may cross trade under these circumstances and recognize costs savings therefrom.

INHERENT SAFEGUARDS

As I mentioned, the Department has identified some concerns regarding the potential it perceives for abusive cross trading. It is important to point out, however, that any abusive cross trading is already unlawful under a number of current rules, regulations, and legal theories. Similarly important and inherent in any potential cross-trade situation, an adviser has no motive to negatively affect the performance of any of its non-proprietary accounts.

Existing Law: Existing laws and regulations provide significant protections against improper cross trading activities. Foremost among these are the general fiduciary obligations applicable to investment managers existing in common law, and under the Investment Advisers Act, as well as ERISA which contains the most comprehensive set of fiduciary principals of any law I am aware of. The strict standard of care, the exclusive benefit rule, and the 406(b) fiduciary self-dealing prohibited transaction provisions of ERISA are alone ample safeguards to address an improper cross trade, even if it otherwise satisfied the objective conditions of a cross-trade class exemption. The anti-fraud provisions of the Advisers Act and securities laws would also deter a cross-trade of securities where the manager had reasons other than the best interests of both clients for effecting the cross trade. The provisions of a standard investment management agreement generally provide a contract cause-of-action to remedy any cross trade not effected in the best interests of the client or one that does not comply with the client's investment guidelines.

Investment Performance: A substantial protection against any potential cross-trading abuses, which already exists in the industry, is the fact that the primary motivating factor for every investment manager is its investment performance. All investment managers know that the way to be the most successful is to provide higher investment performance than other managers. Despite mandated warnings that past investment performance is not a guarantee of future investment results, all of an investment manager's clients and prospective clients focus heavily on the manager's past performance numbers and comparative performance rankings in making decisions on whether to hire or fire a manager. Managers with performance numbers in the top third get new clients, managers with performance in the second third keep existing clients, and managers with performance in the bottom third lose clients. Often the distinction between managers in the top third from those in the bottom third is only a matter of a few basis points. The reason we believe this overarching motivation to achieve the highest investment performance numbers possible serves as a significant safeguard against a manager purposely cross trading a "wrong" security from one account to another is because to do so would hurt the manager's performance numbers.

The Association for Investment Management and Research has issued detailed rules an investment manager must follow in presenting its past investment performance if the manager wishes to state that its performance presentation complies with the AIMR Performance Presentation Standards. The SEC has issued a no-action letter with respect to investment managers presenting their AIMR compliant past performance numbers in mutual fund prospectuses and clients in our industry have begun to expect presentations of past performance to be AIMR compliant.

There are two rules in the AIMR Performance Presentation Standards which we believe are relevant to cross-trading safeguards. First, the Standards require that performance be presented on a composite basis and that all of a manager's accounts managed pursuant to a similar strategy be included in the same composite. Since the performance a manager will be presenting for a particular composite will be the aggregate performance of all accounts in the composite, cross trading a "wrong" security from one client to another would hurt the manager's composite performance and serve as a detriment to the manager's long-term success.

The second AIMR rule relevant to cross trading is that the performance of a new account that is funding does not affect the manager's composite performance until a sufficient amount of time has elapsed for the manager to get the account fully invested in the market. Therefore, it is far better for the manager's composite performance record to purchase the securities in the open market than from other accounts that make up the composite, because such cross trades could reduce the performance of existing accounts. While we do not believe that compliance with the AIMR Performance Presentation Standards should be a condition of any active cross-trade exemption the Department may issue, a requirement that investment managers report their performance on a composite basis may add some protection for covered plans against any cross trading improprieties.

EXEMPTION SAFEGUARDS

While existing law already would address any improper cross trading, we recognize that the Department seeks additional safeguards in crafting an active cross-trade exemption. We believe the Department would be well served to use a combination of the provisions from its recently proposed passive cross-trade exemption and prohibited transaction exemption 86-128, as well as SEC Rule 17a-7 as starting points. PTE 86-128 deals with the conflicts of interest presented when an investment manager trades covered plan accounts with the manager's affiliated broker. These potential conflicts are very similar to those presented by cross trading. In particular, the potential of a manager purchasing the "wrong" security from an affiliated broker because of a self-interest profit motive is similar to the Department's concern that a manager might cross trade a security solely because of the opportunity to do so. In issuing 86-128, the Department had to have determined that its disclosure and consent procedures, annual opt-out procedures, record-keeping and reporting requirements, and pricing policy were sufficient protections. We believe that the same holds true with cross trading.

Pricing Protections: The main abuse cross trading is perceived to present is the ability for an investment manager to trade a security between two accounts at a price other than current market value. *Consequently, the most important safeguard a cross-trading class exemption should contain is one designed to ensure that all cross trades are effected at current market value.* Such a procedure would make it extremely difficult for an investment manager to favor one account over another through cross trading. We also support the inclusion of a restriction requiring securities to have a readily available market quote as an important safeguard against pricing abuses.

Our members feel strongly that in issuing a cross-trading exemption, the Department either should adopt the pricing procedures contained in SEC Rule 17a-7 or should work with the SEC in adopting an agreed pricing procedure that would apply to both a new prohibited transaction class exemption and Rule 17a-7. *The main point is that the pricing mechanisms for covered plans should be identical to those for mutual* *funds.* If covered plans were not able to cross trade with mutual funds because the pricing mechanisms did not line up, a large of number cross-trading opportunities would be missed. Moreover, the examination staffs of both the SEC and the Department would be better able to detect violations of their rules if they were both enforcing the same pricing procedure.

Whatever pricing mechanism is agreed upon, we recommend that it allow cross trades to be effected at current prices rather than closing prices. While this may allow a manager additional latitude to favor one side of the trade by waiting until the manager believes the price has hit an intra-day high or low, it is unlikely that this would happen as the manager has a duty to act in the best interests of both the buyers and sellers. Moreover, our traders believe that this additional flexibility will better enable them to obtain best price for both parties to the trade and will be operationally more effective.

Favored Accounts: The Department's concern that cross trading would facilitate an investment manager's trading the "wrong security" from one account to another is more difficult to deal with than the pricing issue. Nonetheless, we believe that sufficient safeguards are already present and others could be implemented in a new class exemption to address this issue. Additional safeguards that would effectively limit the ability of an investment manager to purchase the wrong security for a covered Plan should focus on what would motivate an investment manager to favor one account over another and prohibit those types of accounts (proprietary accounts) from participating in cross trades. The definition of proprietary account should be broad and include any account containing assets of the investment manager, its affiliates, and employees of either. Pooled funds holding assets of a proprietary account in excess of a stated percentage of the fund's total assets should also be considered proprietary accounts. I note that class exemption 86-128 uses a 20% threshhold which may be an appropriate percentage for a cross-trade exemption.

Disclosure, Consent, and Reporting: Plan approval based on full disclosure and continued reporting should serve as the backbone of any cross-trade exemption the Department issues. We believe that various provisions of PTE 86-128, the proposed passive exemption, and SEC Rule 17a-7 work well to protect covered plans and will not go into great detail on these points. Generally, we recommend that each investment manager develop detailed cross-trade procedures consistent with any class exemption. The manager should fully disclose these procedures to an independent plan fiduciary, who would then decide whether to authorize the plan's participation in a manager's cross-trading program on a general consent basis. The plan should also have the opportunity to opt out of any cross-trading program. The investment manager should be required to provide regular reports to an independent fiduciary of each plan regarding the cross-trade transactions entered into on behalf of the account during the period. The manager should also maintain accurate records of such cross-trading for a specified period.

The one aspect of the consent requirement we would like to stress is that requiring an independent fiduciary's consent prior to effecting each cross trade is unworkable. The market is moving with increasing speed and the cross-trade opportunity may be lost during the time spent tracking down the client on each side. This problem is particularly severe for managers that use model portfolios and/or pro-rata allocation systems and for pooled funds due to the fact any cross-trade opportunity would be allocated across a large number of clients. The time and operational difficulties of obtaining written consent from a large number of clients would cause the crossing opportunity to evaporate.

Additional Conditions to Consider: There are additional protective conditions that a cross trading exemption could contain if the Department finds it necessary. First, any exemption should contain a provision requiring cross-trade opportunities to be allocated among clients according to the manager's existing trade allocation policies. Managers regularly deal with allocating limited investment opportunities among its clients, and cross trades could be allocated in the same manner.

Second, any exemption should require that no brokerage commissions, fees (except for customary transfer fees), or other remuneration would be paid in connection with a cross-trade transaction.

Third, a requirement that cross trades of equity securities can only involve securities which are widely-held and actively traded, as those terms are defined in the proposed passive exemption, should also be included as an important pricing protection.

Fourth, a large plan restriction could help ensure that the independent Plan fiduciaries have sufficient financial expertise and resources to monitor a manager's cross trading activities. We would request that if a large plan restriction were imposed that, for pooled funds, the restriction would be satisfied by the size of the fund rather than applying to each investor in the fund. A requirement that the pooled fund contain a minimum number of investors would be a sufficient condition to ensure that on a collective basis the investors had the resources to monitor crossing activity. If the fund did not have the minimum number of investors, a look-through to the individual plan size should apply.

Fifth, the Department should also require that any cross-trade transaction be consistent with other account guidelines applicable to the client.

Finally, although our members strongly believe a significant benefit of cross trading is to neutralize market impact, in the event the Department disagrees, the inclusion in a class exemption of conditions such as some type of restriction on volume or the quality of the security involved would sufficiently deter any potential abuse the Department perceives to exist.

Conclusion: In closing, it is abundantly clear that many of the participants in our industry, clients and managers alike, believe that the benefits of cross trading outweigh its risks. The Department should allow those fiduciaries who hold this opinion to make their own decision on this issue. An appropriate exemption should be adopted that requires covered plan fiduciaries to give informed written consent, requires reporting and record keeping, and includes pricing and other limiting conditions. These conditions would provide sufficient protection for covered plans from potential self-dealing or impropriety, yet permit plans to obtain the benefits of cross trading enjoyed by other clients.

We thank you for giving the ICAA the time to present its views on this important topic. We look forward to working with you in the future to craft a workable class exemption for actively managed accounts and welcome any questions you may have of us today.

February 14, 2000

Pension & Welfare Benefits Administration
U.S. Department of Labor
Office of Exemption Determinations, Room N-5649
ATTN: "Class Exemption for Securities Cross-
Traded By Index/Model-Driven Funds"
200 Constitution Avenue, N.W.
Washington, D.C. 20210

RE: Department of Labor Notice of Proposed Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds, 64 Fed. Reg. 70057 (December 15, 1999)

Ladies and Gentlemen:

The Investment Counsel Association of America (ICAA)[1] appreciates the opportunity to comment on the Department of Labor's proposed class exemption for cross-trades of securities by index and model-driven funds, published in the Federal Register, Vol. 64, No. 240 on December 15, 1999 (Proposed Class Exemption). The Proposed Class Exemption, if granted, would allow investment managers who manage accounts based on passive index tracking or model driven strategies to trade securities between specified accounts under certain circumstances and conditions. The proposal is somewhat similar, but not identical, to the individual exemptions that the Department has granted previously in this area.

The ICAA commends the Department on taking this step toward permitting pension plans to benefit from cross-trades. As proposed, however, the class exemption would affect few, if any, ICAA members; our members, for the most part, actively manage accounts and/or use model portfolios that do not meet the definition of a Model-Driven Fund as set forth in the proposal.[2] Therefore, the ICAA greatly prefers that the Department issue a class exemption for actively managed accounts as well as passively managed accounts at the same time.

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[1] The ICAA is a national not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 250 investment advisory firms that collectively manage funds in excess of $2 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[2] Indeed, in the Notice of Proposed Class Exemption, the Department estimates that only ten entities "will seek to take advantage of the class exemption in a given year." Proposed Class Exemption at p. 9.

Our May 19, 1998 letter, issued in response to the Department's request for comments two years ago,[3] and our testimony before the Department last week emphasize our strong view that a broad class exemption for cross trades should be issued. As noted in our May 1998 letter, "the ICAA believes that cross-trade transactions occurring between two managed accounts are clearly in the best interests of both clients because they reduce or eliminate unnecessary and often substantial transactions costs – particularly brokerage commissions on equity securities and dealer margins on debt instruments and other securities typically traded on a principal basis."[4] The result of the lack of an exemption is that "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."[5]

As discussed in our May 1998 letter and in the testimony of virtually all of the witnesses last week, the benefits of cross trading are identical regardless of management style (passive or active). We also believe strongly that the risks the Department perceives to be inherent in cross trading are no greater for active managers than for passive managers, particularly when limited to the same or similar conditions precedent. As a corollary, the findings the Department would have to make to meet its statutory requirements would be substantially the same for both active and passive class exemptions.[6] Thus, we believe it is inappropriate for the Department to issue the proposed rule in its current form, particularly if no exemption for active cross trades is issued.

If, however, the Department determines to continue to pursue these issues in a bifurcated fashion, the ICAA respectfully requests that, at a minimum, the Department modify the "passive" proposal somewhat to permit investment advisers who do not manage index or model-driven funds to cross trade under very similar conditions (i.e. *triggered passively*) to those in the proposal.[7] Specifically, we request that the proposed

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3 The ICAA's May 1998 letter (May 1998 letter) responds to the Department's request for comments in its notice entitled "Cross-Trades of Securities by Investment Managers," 63 Fed. Reg. 13696 (March 20, 1998).

4 May 1998 letter at 1.

5 *Id.* at 2.

6 In the passive proposal, the Department states: "In order to ensure that this exemption meets the statutory requirements, the Department finds it necessary that certain information be provided to an independent fiduciary of each plan that invests in an Index or Model-Driven Fund, and that the independent fiduciary approve the plan's participation in a cross-trading program." Proposed Class Exemption at p. 9.

7 As we testified at the February 10, 2000 hearing, there are many types of "triggers" of cross-trade opportunities, the vast majority of which could be deemed "passive" or client-initiated. In recognition of this reality, the Department should enact a broad cross-trade exemption for actively managed accounts that could require the investment manager to record the reason or "trigger" of the cross-trade. We have selected the two proposals discussed here because they modify, and integrate appropriately, with two concepts already selected by the Department in its "passive" proposal: liquidating accounts and model-driven

exemption be modified: (1) to permit cross trading more broadly where an account is liquidating its securities holdings; and (2) to permit cross trading where managers employ models under certain circumstances not currently within the scope of the proposal. We also support a uniform exemption for all "passive" managers.[8]

I. Liquidating Accounts

The class exemption, as proposed, would permit a liquidating account to cross-trade with a "Fund," defined to mean an index or model-driven fund. Presumably, the Department has determined that liquidating accounts should be able to cross-trade because the account's owner or independent fiduciary – not the investment manager – makes the decision to liquidate a portfolio of securities. For the same reason, we believe that the adviser should not be constrained in the type of fund willing to accept the securities from the liquidating account. Under the exemption, the adviser would not have discretion to determine whether a pension or other account will be liquidated; thus, the Department's concern that active managers might create cross-trade opportunities to the detriment of pension accounts simply is not present in this situation. Accordingly, we request that the Department permit actively managed accounts generally to participate in cross trading opportunities that arise because of account liquidations.

Clients tend to liquidate accounts (wholly or partially) at month and quarter ends at the same time that other clients are funding new accounts or adding funds to existing accounts. Because active managers, like passive managers, frequently hold the same securities for multiple clients, whenever an account is liquidating at the same time another account is funding, cross trade opportunities present themselves. Even if the manager does not hold similar securities across all of its accounts, a manager would have no incentive to purchase securities from a liquidating account if the manager did not think they would benefit existing accounts. As discussed in our testimony last week, a manager may appropriately cross a trade for a liquidating account with a trade for another account under a variety of other scenarios. Further, implementation of fair pricing rules would sufficiently protect the liquidating account by ensuring that its sales are effected at current market values. As long as sales are done at market, cross trading could only benefit the liquidating account by eliminating its commission costs.[9]

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portfolios. We emphasize, however, that the Department's relief on the cross-trades issue should not be so limited.

[8] Because the Proposed Class Exemption in its current iteration does not affect our members, the ICAA is not submitting comments on the specific details of the proposal.

[9] A further safeguard is that a client liquidating a separate account always has the unilateral right to retain rather than sell the securities. A client liquidating a pooled fund account may not have this right. However, a manager's pooled funds, including in-house pooled funds, should be permitted to participate in cross trading opportunities as long as proprietary accounts do not represent more than 20% of the pooled fund.

II. Actively Managed Models

Many investment advisers manage client accounts pursuant to model portfolios. All of the manager's client portfolios whose objectives comport with the model are managed to the same model.[10] Because the managers have full discretion to alter the models, they do not constitute model-driven strategies, as defined in the current proposed exemption, and do not qualify for the relief the Department has previously granted in this area. Nevertheless, all of the attributes of passive management that the Department felt were sufficient to issue the proposal are also present when managers employ actively managed models under certain circumstances.

The primary event that gives rise to cross trades for managers using actively managed models is when an account is liquidating. We have discussed that scenario above. Another scenario giving rise to cross-trading opportunities is when a manager changes its model at a time when one or more clients are funding new accounts or adding to existing accounts.[11] Again, with pricing protections and a "passive" triggering event, a manager would have no incentive to cross trade to benefit itself or a particular client.[12] If the Department still feels concern about managerial incentives in this "passive" context, it could permit cross-trades arising under this scenario only if the new fundings represented less than a stated percentage of the manager's existing assets being managed to the model in question and could prohibit cross-trades with proprietary accounts.

III. Effect on Existing Exemptions

The Department has requested comment on whether managers should be permitted to rely on the terms of existing individual exemptions, rather than the differing terms of the proposed class exemption, if granted. The proposed exemption generally would not assist ICAA members at this time. We are concerned, however, about the effect of this proposal on members who may wish to establish index or model-driven funds in the future. By permitting certain firms to continue to rely on individual exemptions that have, in some respects, less stringent conditions than the proposed class exemption, the Department would create a competitive advantage for advisers who already have exemptions.[13] As it is, the Department is already creating a competitive

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[10] To the extent a client specifies security-specific restrictions, the model will be amended to comply with such restrictions. Some managers will maintain a list of alternate securities that are regularly used to satisfy common restrictions, such as defense and tobacco restrictions. Other managers will invest the cash across the remaining portfolio.

[11] Note that managers do not alter their models on a trade-by-trade basis, but rather on a security –by-security basis. Thus, this scenario presents no ability to manipulate any given trade.

[12] As we discussed in our testimony, the typical opportunities to cross trade do not present a manager with incentives to benefit one client over another.

[13] We understand that when active managers compete for the same business as passive managers (those with individual exemptions), the passive managers sometimes tout their ability to minimize trading costs through cross trading as an advantage over active management.

advantage for firms that "passively," rather than actively, manage funds. We urge the Department to hold all firms to the same standard, at least with respect to the exemption proposed.

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The ICAA continues to believe that cross-trade transactions occurring between two managed accounts (passive or active) are in the best interests of both clients when conducted under appropriate conditions. We therefore strongly request that the Department modify the Proposed Class Exemption to permit cross trading where the proposed "passive" triggers are present. We also reiterate that the ICAA supports a more broad class exemption for cross trades between accounts actively managed by the investment adviser.

Thank you for the opportunity to provide comments regarding the Proposed Class Exemption. If you have any questions or if the ICAA can be of additional assistance in formulating a practical, effective rule for cross-trade transactions, please do not hesitate to contact the undersigned.

Sincerely,

Karen L. Barr
General Counsel

cc: Leslie B. Kramerich, Esq.
Alan D. Lebowitz, Esq.
Ivan L. Strasfeld, Esq.
Louis J. Campagna, Jr. Esq.
Michael Schloss, Esq.
E. F. Williams, Esq.
Paul F. Roye, Esq.

March 31, 2000

VIA U.S. MAIL AND ELECTRONIC FILING

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0609

Re: *Privacy of Consumer Financial Information (Regulation S-P), Release Nos. 34-42484, IC-24326, IA-1856; File No. S7-6-00*

Dear Mr. Katz:

The Investment Counsel Association of America, Inc.[1] appreciates the opportunity to comment on the Commission's proposed Regulation S-P[2] implementing notice requirements and restrictions on sharing consumer information as mandated by the Gramm-Leach-Bliley Act.[3]

The proposal would require financial institutions, including all federally registered investment advisers, to adopt policies and procedures that are reasonably designed to insure the security and confidentiality of consumer records, protect against threats or hazards to the security of customer records, and protect against unauthorized access to consumer records. The proposal also would require a financial institution to provide an initial notice of its privacy policy and practices in two circumstances: (1) upon entering into a *customer* relationship; and (2) prior to disclosing nonpublic personal information about a *consumer* to a nonaffiliated third party. Financial institutions will be required to issue annual notices to customers with whom an ongoing relationship exists and permit customers to stop a financial institution, in the form of an opt-out notice, from disclosing nonpublic personal information to certain nonaffiliated third parties. The release indicates that the regulation will likely become effective November 13, 2000 and require financial institutions to deliver initial privacy notices within 30 days of the

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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 today consists of over 250 investment advisory firms that collectively manage in excess of $2 trillion for a wide variety of institutional and individual clients. For more information, please see the ICAA's web site at www.icaa.org.

2 SEC Release Nos. 34-42484, IC-24326, IA-1856, File No. S7-6-0 (Mar. 2, 2000), 65 FR 12354 (March 8, 2000).

3 Pub. Law No. 106-102 (1999).

effective date.

I. INTRODUCTION

As the SEC recognizes, due to the fiduciary relationship between an investment adviser and client, investment advisers generally do not disclose client information to other parties.[4] In addition to the client confidentiality implicit in a fiduciary relationship, all ICAA member firms are required to endorse the ICAA *Standards of Practice*, which since 1937 have required client confidentiality. The *Standards of Practice* currently state: "Information concerning the identity of security holdings and financial circumstances of clients is confidential."[5] The ICAA's specimen advisory contract, which is distributed to all ICAA member firms, also contains a confidentiality provision stating: "All information and advice furnished by either party to the other shall be treated as confidential and shall not be disclosed to third parties unless requested by a regulatory authority or otherwise as required by law."[6]

The Gramm-Leach-Bliley Act is intended to prevent abusive practices that violate a customer's reasonable privacy expectations. Such abusive practices include the sale to nonaffiliated third parties of sensitive customer information or customer lists by financial institutions. We are unaware of any evidence indicating that these types of abusive practices exist in the investment advisory profession. Even disregarding that client confidentiality is an important aspect of an adviser's fiduciary obligations, it simply does not make sense from a business point of view for investment advisers to share client information with nonaffiliated third parties unless it is required or desirable as part of the advisory relationship. In fact, due to the highly competitive nature of advisory services, we believe it is the norm in the investment advisory profession for firms to guard client information jealously.

While it is our firm belief that advisers generally do not participate in the types of abusive practice that the law is intended to address, it is nonetheless true that investment advisers do and must share nonpublic personal information with other entities – often third-party nonaffiliates – in the normal course of business. Typically, an investment adviser will share nonpublic personal information with the custodian of the client's assets, one or more broker-dealers, and, in certain circumstances, third-party service providers (such as providers of portfolio management services). Given the wide disparity among advisory firms, the nature and number of third-party relationships may vary significantly from firm to firm.

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4 "[We] assume that most investment advisers do not share [nonpublic personal] information with any third parties." Release at 12366.

5 For the full text of the ICAA *Standards of Practice*, please see the ICAA web site at www.icaa.org.

6 *The ICAA Investment Adviser*, Volume 2, pg. II-23.

We strongly support a commonsense approach to privacy regulation – one that focuses on abusive practices the law intends to address *without imposing needless regulatory requirements on transactions and practices that are integral to or authorized by the advisory relationship.* We commend the Commission for recognizing the fact that investment advisers typically have not engaged in the types of abusive practices that the Gramm-Leach-Bliley Act seeks to eliminate. We likewise commend the Commission for working with other agencies in issuing the proposed regulations within a very short period of time. We appreciate the opportunity to provide these comments and believe that explicit clarification on the issues identified below is necessary and desirable to provide more certainty and to avoid confusion on issues that may arise when an adviser provides nonpublic information to nonaffiliated third parties.

II. REQUESTS FOR CLARIFICATION

While many investment advisers already have privacy policies, conforming them to the Commission's standards and instituting the notice requirements will require a significant effort. To that end, to the extent the Commission can issue specific guidance in the adopting release, both investment advisory professionals and consumers will be better served. The ICAA requests the Commission to address the following specific areas in the adopting release: (A) definitions of consumer and customer; (B) exceptions to the notice and opt-out requirements; (C) limits on third-party redisclosure and reuse; (D) content of the initial and annual notices; and (E) wrap fee and subadvisory accounts.

A. Scope of the Regulation: Definition of Consumer and Customer

The definitions of consumer and customer are the keys to determining if and when a financial institution must issue the privacy and opt-out notices. These definitions must be clear so it is readily apparent when a financial institution must issue the notice. The proposal defines consumer, and thus derivatively customer,[7] as an "individual who obtains or has obtained a financial product or service from you that is to be used primarily for personal, family, or household purposes, and that individual's legal representative."[8] The term "individual" is not defined. However, the Commission implies that it has a meaning different from "natural person."[9]

In an advisory relationship where the client is a natural person, applying the consumer definition will be straightforward. Similarly, an investment adviser's relationship with institutional clients plainly will not come under the auspices of the

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7 "Customer means a consumer who has a customer relationship with you." Section 248.3(j), Release at 12371.

8 Section 248.3(g)(1), Release at 12370.

9 "We also request comment on how the opt out right should apply to an investment adviser who manages a trust account on behalf of multiple beneficiaries." Release at 12362. If the Commission treats "individual" as a "natural person," an investment adviser would not have to issue privacy or opt-out notices to clients that are not natural persons, *e.g.*, a trust.

notice and opt-out provisions. However, because “individual” is undefined, it is not clear whether or how the regulation applies in circumstances where the client is not a natural person. For example, an investment adviser may have clients that are trusts, limited partnerships, retirement accounts, general partnerships, or non-traditional corporate accounts, any of which may have some element of personal, family, or household purpose. Yet, the individuals behind these entities are not parties to the advisory contract. Are these accounts “customers”?

Because the term “individual” currently provides no guidance, the definition of consumer appears to turn on whether the financial service is primarily provided for personal, family or household purposes. It may be difficult to make this facts-and-circumstances determination on a case-by-case basis under the current definition. We therefore request that the Commission issue a definition for the term “individual” or provide a safe harbor for situations where the account is not in the name of a natural person. For example, under a safe harbor, advisers could assume that trusts and individual retirement accounts are consumers, while general partnerships, other retirement plans, and corporate accounts are not.

The ICAA also is concerned about the effect the regulation may have on an investment adviser whose only clients are institutions – which do not meet the consumer or customer definitions. The proposed regulation appears to require *all* registered investment advisers to adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. But investment advisers that only have institutional clients will not have to issue privacy and opt-out notices because those provisions of the regulation apply only to “consumers.” Further, since institutional-only advisers would not have customer information, the adoption of policies and procedures to safeguard such information is pointless. Thus, the ICAA respectfully recommends amending the proposal to clarify that policies and procedures will only be required of investment advisers that have consumers as clients.[10]

B. Exceptions to Privacy Notice and Opt-out Provisions

The Gramm-Leach-Bliley Act sets out several exceptions to when a financial institution is required to send a privacy and opt-out notice.[11] The SEC’s proposal would incorporate the Act’s exceptions at Sections 248.9, 248.10, and 248.11. These exceptions permit a financial institution to disclose nonpublic personal information to third-party

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10 Investment advisers with a primarily institutional clientele often have natural persons as accommodation clients. With respect to such accommodation clients, the regulation should apply.

11 The exceptions are established in Sections 502(b)(2) and 502(e) of the Act. Section 502(b)(2) provides an exception from the opt-out provisions if a financial institution enters into a contractual agreement with a nonaffiliated third party to perform services for or functions on its behalf, or if services are offered pursuant to a joint agreement. Section 502(e) permits a financial institution to share information with a nonaffiliated third party in certain circumstances, including: (1) to effect, administer, or enforce a transaction requested or authorized by the consumer, (2) with the consent of the consumer, or (3) to prevent fraud.

nonaffiliates without giving the consumer the right to opt out. Further, some of the exceptions provide that a financial institution does not have to disclose in its privacy notice the details of with whom it shares the nonpublic information.

Section 248.9 provides an exception to the opt-out provision only – notice is still required – if a financial institution shares information with service providers or joint marketers.[12] For a financial institution to rely on this exception it must fully disclose to the consumer, before releasing the nonpublic personal information, the types of third parties it provides information to and what types of information it releases.[13] The financial institution also must enter into a contract with the third party designed to ensure that the third party will maintain the confidentiality of the information and will use the information solely for the purposes for which it is disclosed.

Section 248.10 is an exception generally for servicing or processing a transaction at the consumer's request.[14] Section 248.11 covers other miscellaneous exceptions in the Act, such as sharing nonpublic information with the consent of the consumer or as required by local law.[15] Sections 248.10 and 248.11 are different from Section 248.9 in that a financial institution relying upon them does *not* have to include details in the privacy notice regarding its disclosure of nonpublic personal information to third-party nonaffiliates. The regulation does require that a financial institution generally include in its privacy notice that it is making disclosures to third-party nonaffiliates as permitted by law.[16]

As noted earlier, investment advisers share nonpublic personal information with third-party nonaffiliates, some of which may have a separate customer relationship with the advisory client. For example, when a person enters into a contract with an investment adviser the person also enters into an agreement with a custodian – typically not affiliated with the investment adviser – to hold its assets.[17] The custodial agreement establishes that the investment adviser has discretion to direct the investment of the assets in custody

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12 *Exception to opt out requirements for service providers and joint marketing*. Section 248.9, Release at 12374.

13 Full disclosure consists of a separate description in the privacy notice of the categories of information the financial institution discloses and the categories of the financial institutions with whom it has contracted. Section 248.6(a)(5), Release at 12373.

14 *Exceptions to notice and opt out requirements for processing and servicing transactions*. Section 248.10, Release at 12375.

15 *Other exceptions to notice and opt out requirements*. Section 248.11, Release at 12375.

16 "…When describing the categories with respect to those parties, you are only required to state that you make disclosures to other nonaffiliated third parties as permitted by law." Section 248.6(b), Release at 12373.

17 Custodians are typically banks or broker-dealers, both of which come under the auspices of the Gramm-Leach-Bliley Act's privacy provisions. When a person opens an account with a custodian, the custodian will also have to deliver its own privacy and opt-out notice.

and that the custodian will act in accordance with the adviser's directions. The investment adviser also must interact with one or more broker-dealers to buy and sell securities on the client's behalf. This interaction necessarily will include nonpublic information such as custodial and transaction information. Thus, a constant stream of nonpublic personal information is shared between the investment adviser, custodian, and broker-dealers to effectuate an investment adviser's investment decisions for the client.

When an investment adviser shares information with nonaffiliated custodians and broker-dealers, the investment adviser is excepted under Section 248.10 from both the notice and opt-out restrictions of the proposal. However, in certain circumstances, sharing information between an adviser and nonaffiliated third parties takes on characteristics of more than one of the exceptions provided for in the regulation. The sharing of information most logically fits into the exceptions under Section 248.10(a)(1) or (2), as "necessary to effect … a transaction requested or authorized by the consumer" or to "service or process a financial product or service requested or authorized by the consumer." Accordingly, we request the SEC to confirm that, with respect to investment advisers sharing information in the normal course of business with broker-dealers and custodians, the notice and opt-out provisions do *not* apply.

Similarly, an investment adviser often retains the services of a third party to perform account maintenance, transfers and recordkeeping functions, manage proxy voting, prepare and deliver account statements, or perform other services for a customer's account. These arrangements should also be excepted under Section 248.10 and not Section 248.9, even though both could apply. Although by title the Section 248.9 exception includes service providers, the substance of the services provided by the parties an investment adviser may retain are more akin to the Section 248.10 exception to "service or process a financial product or service" requested by the consumer. We request the Commission to clarify that the substance of the service the nonaffiliate is providing will dictate the exception on which the financial service provider relies, *i.e.*, if a service provider is performing a function that a financial institution or consumer initiates to service or process a financial product or service, the applicable exception is Section 248.10.

As a corollary, the ICAA requests the Commission to clarify that the Section 248.10 exception is not solely a "transactional" exception, but also applies when a financial institution's service is based on a relationship. The proposed title of the section indicates that the exception is for processing and servicing transactions.[18] An investment adviser may retain third-party nonaffiliates to perform services on behalf of the customer that are not transaction oriented. The ICAA believes, as indicated above, that these types of services are excepted under Section 248.10 because the third-party nonaffiliate is facilitating a financial product or service – not a transaction – requested by the

[18] *Supra,* fn. 15.

consumer.[19] Because these services are not transactional in nature, we recommend that the Commission recharacterize the title and text of the exception to include the words "transactions or accounts" where it currently references only "transactions." For example, the title of the section should be renamed as, "Exceptions to notice and opt out requirements for processing and servicing transactions *or accounts*."

The ICAA also suggests that the Commission amend proposed Section 248.11(a)(1) to clarify that a financial institution is excepted from the privacy notice and opt-out provisions if it provides nonpublic personal information to a third-party nonaffiliate at the direction of the consumer's representative or fiduciary.[20] The rule permits a financial institution to disclose information with the consent or at the direction of the consumer and also permits disclosure to a person acting in a fiduciary or representative capacity on behalf of the consumer, but does not explicitly permit disclosure to a third party with the consent or at the direction of a consumer's fiduciary or representative. Incorporating the proposed amendment will permit custodians, broker-dealers, and other third-party nonaffiliates to release nonpublic personal information at the request of the investment adviser. For instance, advisory clients often request performance reports on their accounts. The investment adviser should be able to instruct the custodian to release its clients' nonpublic personal information to the performance reporting company, and the custodian should be able to rely on that instruction without having to obtain independent approval by the customer. Similarly, high net worth clients sometimes retain consultants, who should be included in the permissible information flow. This amendment would not substantively expand the exception, but streamline its operation. Clarifying all the exceptions to the fullest extent practicable will assist the industry greatly in implementing the regulation.

C. Limits on Redisclosure and Reuse of Information

Proposed Section 248.12 limits the redisclosure and reuse of information by third-party nonaffiliates when they receive nonpublic personal information. The Release states that when a nonaffiliated third party receives nonpublic personal information from a financial institution, it is subject to the same restrictions as the financial institution itself. Further, a nonaffiliated third party may use the information received under one of the exceptions to the notice and opt-out provisions (Sections 248.9-.11) only for the purpose for which the information was provided.

Investment advisers share nonpublic financial information with other entities as necessary to service their client's account. Because the information sharing will likely come under one of the exceptions to the notice and opt-out provisions of the regulation,

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[19] Section 248.10 excepts disclosures from the notice and opt-out requirements if a financial institution discloses nonpublic personal information "to service or process a financial product or service requested or authorized by the consumer." Release at 12375.

[20] The requirements for initial notice and opt out do not apply when you disclose nonpublic personal information "(1) with the consent or at the direction of the consumer…[or] to persons acting in a fiduciary or representative capacity on behalf of the consumer…" Section 248.11(a), Release at 12375.

the customer will not have the ability to opt out or be explicitly notified that their information is being shared. Thus, third-party nonaffiliates that receive nonpublic personal information should not be permitted to use the information for any other purpose. For example, if an investment adviser releases client information to a broker-dealer to allocate a block trade of securities, the broker-dealer and its affiliates should not be able to use such information to market its services to the adviser's clients.

The ICAA requests the SEC to confirm that Sections 248.12(a)(2)[21] and 248.12(b)(2)[22] require third-party nonaffiliates to use nonpublic information *only* for the purpose for which it was received. Accordingly, we suggest that the language be rephrased in the negative. Because the intent of the rule is to limit the use of the information and the previous subsection is stated in the negative, the effect may be clearer if it provides: "You may not use nonpublic personal information about a consumer that you receive from a nonaffiliated financial institution in accordance with an exception under Sections 248.9, 248.10, or 248.11 except for the purpose for which the information was provided to you."

D. Content of Initial and Annual Notices

Because the fiduciary relationship between investment advisers and their clients requires confidentiality, the initial and annual notices of an investment adviser's privacy policies and practices are likely to be brief. Many of the disclosures required in Section 248.6 – including the categories of nonpublic personal information that are disclosed, the affiliates and nonaffiliated third parties to whom information is disclosed, the information about former customers that is disclosed, and the description of the information disclosed pursuant to a service contract – do not apply to investment advisers that maintain client confidentiality.

For financial institutions that do not disclose nonpublic personal information to affiliates or nonaffiliated third parties, an example of a simplified notice is included in Section 248.6. The simplified notice consists of a statement that the financial institution does not disclose nonpublic personal information to affiliates or nonaffiliated third parties, the categories of nonpublic personal information that the financial institution collects, the policies and practices adopted to protect the confidentiality, security, and integrity of nonpublic personal information, and a disclosure that information is disclosed to nonaffiliated parties as permitted by law if the financial institution relies on the exceptions to the notice and opt-out provisions in Sections 248.10 or 248.11.

The ICAA believes that many investment advisers will be able to satisfy the notice requirements of the regulation by delivering the simplified notice to their

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21 Section 248.12(a)(2) limits a financial institution's disclosure of nonpublic personal information it receives from a nonaffiliated financial institution. Release at 12375, 12376.

22 Section 248.12(b)(2) limits a third-party nonaffiliate's disclosure of nonpublic personal information it receives from a financial institution. Release at 12376.

customers. As proposed, the simplified notice is included as an *example* of how to comply with the regulation. This approach is at odds with the banking regulators' in that compliance with the examples are not safe harbors but are only issued as guidance.[23] To provide certainty in applying the regulation, we request that the SEC promulgate the simplified notice concept as part of the rule itself and not merely as an example to the rule. In the alternative, the SEC could take the banking regulators' approach of deeming the examples to be safe harbors.

E. Wrap Fee Programs and Subadvisory Accounts

Many investment advisers are engaged as money managers for wrap fee programs or retained as subadvisers by other investment advisers. Depending on how the relationship between the investment adviser, client, and sponsor of a wrap arrangement is structured, the investment adviser may or may not have direct customer contact. Similarly, investment advisers retained as subadvisers rarely have access to detailed information regarding the individual clients of the originating investment adviser. Where investment advisers do not have significant customer contact, the ICAA believes the Commission should not require the adviser to issue a privacy notice or should clarify that the entity with principal customer contact – the wrap sponsor or originating investment adviser – has the responsibility to issue the privacy notice.

Wrap fee programs typically are established either with individualized contracts between the investment adviser and client or through a master agreement between the investment adviser and the sponsor. If the investment adviser has direct client contact (which usually includes an advisory contract) the privacy regulation should apply. However, where a wrap fee program is established with a master agreement between the investment adviser and sponsor, the sponsor often collects the clients' personal nonpublic information for the benefit of the investment adviser. Account statements and subsequent communications also are created and sent to the client by the sponsor. In this context, the investment adviser is given only the individualized information that is necessary to manage the account and generally does not have direct contact or access to the client. Under the proposed regulation the wrap fee clients would have a customer relationship with the investment adviser, but the adviser may not have the necessary information to deliver the required notice.

Similarly, investment advisers engaged by other investment advisers as subadvisers typically do not have access to detailed customer information. The subadviser may only be given cursory account information and a lump sum of money to invest deploying a specific investment strategy. There may be little, if any, contact between the subadviser and the end client.

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[23] "The banking agencies' proposal provides that, to the extent applicable, compliance with the examples would constitute compliance with the applicable rule. See, e.g., Banking Agencies' Proposal, proposed §§ 40.2, 216.2, 332.2, 573.2. The examples in [the SEC's] proposed rules, however, would not provide the same safe harbor. The examples are intended to describe ordinary situations that would comply with the applicable rule, but the particular facts and circumstances relating to each specific situation will determine whether compliance with an example constitutes compliance with the rule." Release at fn. 5.

The release indicates that the SEC believes that omnibus clearing brokers do not have a consumer or customer relationship with the clients of the introducing broker-dealer.[24] While the master wrap fee and subadvisory arrangements are not entirely analogous to the omnibus clearing arrangement, the circumstances are similar enough to warrant relief from the notice and opt-out requirements if the investment advisers engaged in these types of arrangements do not have access to detailed customer information.

If the SEC does not issue relief in this context, the ICAA supports the adoption of the joint notice concept discussed in the proposal. A joint notice would permit the broker-dealer and investment adviser to have one notice in the wrap fee context, as well as all subadvisers to an account. We support expanding the joint notice concept to permit a financial institution that maintains the client contact in such situations to have the sole responsibility for sending the privacy notices to joint customers.

III. SPECIFIC QUESTIONS POSED IN THE RELEASE

A. Should the definition of nonpublic personal information cover information about a consumer that contains no indicators of a consumer's identity?

The definition of "nonpublic personal information" should exclude information that includes no indicators of a consumer's identity. Preventing a financial institution from disclosing anonymous information does not further the intent of the privacy provisions of the Gramm-Leach-Bliley Act and actually may act as a disservice to consumers. Financial institutions disclose nonpublic information to third-party nonaffiliates for legitimate purposes, such as measuring the risk or verifying the return of a portfolio. Investment advisers also may commission studies to analyze statistical characteristics of their accounts. Although nonpublic personal information is disclosed to third-party nonaffiliates, it is done to benefit the consumer and the investment adviser. Absent identity-type information, there is no compelling threat of abuse and little gain in requiring a financial institution to include these types of disclosures in its notice.

B. Who should receive notice in situations in which there is more than one party to an account? How should the right to opt out apply in joint accounts? How should opt out rights apply to an investment adviser who manages a trust account on behalf of multiple beneficiaries?

Where there is more than one party to an account, the privacy notice should be sent to the party or parties that control the account. For investment advisers, the party that receives the privacy notice should be the signatory to the advisory contract or, absent

[24] "An individual who has an account with an introducing broker and whose securities are carried by a clearing broker in a special omnibus account in the name of the introducing broker is not a consumer for purposes of the clearing broker if it receives no nonpublic personal information about the consumer." Release at 12356.

a contract, the individual that has the authority to terminate the relationship with the investment adviser. Further, if multiple parties to an account would receive the privacy notice at the same address, the investment adviser should have the authority to "household" the notice.[25]

With respect to providing opt-out rights where there is more than one party to the same account, the SEC should promulgate a flexible rule permitting the financial institution to develop an appropriate practice. The assumption for the rule should be that if one party to an account opts out of information sharing, that opt out is binding on all the other parties to the account. However, if a financial institution wants to provide opt-out notices to individual parties to the same account, and cope with the resulting tracking issues, the rules should provide for that option.

The Commission specifically requests comment on how the opt-out requirement should apply to trust accounts. Assuming that a trust meets the definition of "customer," we believe the trustee in its sole discretion should have the authority to opt out. A trustee has a fiduciary obligation to the beneficiaries of the trust to act in their best interest. Additionally, investment advisers rarely have contact with individual beneficiaries. The regulation thus should clarify that an adviser may rely upon a trustee's decision whether to opt out.

C. What methods do financial institutions anticipate using to provide the notices?

The ICAA believes most investment advisers will issue the required privacy notice with other account documents. The initial notice to a new customer will likely be delivered with, or as part of, the advisory contract or the adviser's brochure.[26] Annual notices are likely to be included in account statements, but also may be included with the required annual delivery, or offer of delivery, of the adviser's brochure. Although these are the likely methods of delivery, investment advisers should not be limited to these options. Some advisers may have separate mailings while others may wish to implement an electronic delivery system.

D. Should the SEC require a financial institution that discloses nonpublic personal information to a nonaffiliated third party to develop policies and procedures to ensure that the third party complies with the limits on redisclosure of that information?

The SEC should not require a financial institution that discloses nonpublic personal information to a third-party nonaffiliate to develop policies and procedures to monitor the nonaffiliate. First, establishing effective policies and procedures would be

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[25] *Delivery of Proxy and Information Statements to Households*, Rel. Nos. 33-7767, 34-42102, IC-24124, File No. S7-26-99 (Nov. 5, 1999).

[26] Rule 204-3 of the Investment Advisers Act of 1940 requires an adviser to deliver its brochure at least 48 hours prior to entering into an advisory contract or at the time of entering into the contract. Use of a separate privacy heading in the advisory contract or Form ADV should be deemed "clear and conspicuous."

very difficult because the party to be monitored is a nonaffiliated entity. Second, with no affiliate relationship, the third party has little incentive to permit the financial institution access to determine its compliance. Third, few financial institutions and companies servicing the industry are going to risk regulatory action and the potential loss of business to violate the limitations placed on them by the privacy laws. Finally, a financial institution that legally discloses nonpublic personal information to a third-party nonaffiliate should not face liability for the actions of a nonaffiliate.

E. How long will financial institutions need to implement the final rules as adopted and when should they be required to deliver notices to existing customers?

The Gramm-Leach-Bliley Act requires the Commission to promulgate final privacy rules 6 months from enactment of the law, but gives the agency flexibility to prescribe the effective date.[27] As stated in the Release, the Commission does not intend to make the privacy regulation effective until at least six months after adoption of the final rules. In addition, the Commission proposed a transition rule that would give financial institutions 30 days from the effective date of the regulation to deliver privacy notices to existing customers.

Although the ICAA anticipates that many investment advisers will issue the simplified privacy notice, the proposed effective date of November 13 is too ambitious. Large financial institutions may wish to develop comprehensive policies and procedures, which will necessitate integrating tracking mechanisms into existing computer systems. At a minimum, the ICAA requests that the regulation not take effect until January 1, 2001. Regardless of the effective date, the transition rule should be altered to permit investment advisers to coordinate their privacy notices with other account mailings that typically take place at year-end. Most investment advisers send year-end account statements as well as tax reporting forms to clients at the beginning of the year. Therefore, the ICAA requests the Commission to adopt a rule such that financial institutions have at least until mid-February 2001 to issue initial notices to existing customers.

IV. STATE AND FEDERAL GOVERNMENT COORDINATION

Although we realize the SEC cannot alter the provisions of the Gramm-Leach-Bliley Act, the ICAA is very concerned with the provision of the Act that permits states to adopt privacy provisions that are not consistent with the federal standard.[28] Press reports have indicated that many states are considering doing just that. While the ICAA does not necessarily oppose tougher privacy laws, we have consistently opposed duplicative and inconsistent standards among and between the SEC and the various states. The ICAA suggests that the SEC work with state governments, state agencies

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27 *See* Section 504(a)(3) and Section 510, Pub. Law No. 106-102 (1999).

28 *See* Gramm-Leach-Bliley Act, Relation to State Laws, Section 507, Pub. Law No. 106-102 (1999).

and/or other federal agencies to the fullest extent possible to harmonize privacy policies across the United States with respect to federally registered investment advisers.[29]

V. CONCLUSION

Maintaining a consumer's personal privacy is an important issue in today's electronic age. The ICAA believes the interests of the consumer are best served with a regulation that does not impede the delivery of financial services, yet provides the consumer with a simple and concise notice that is easy to comprehend. For the most part, we believe the SEC has proposed such a regulation.

The ICAA commends the Commission staff for issuing such a thorough proposal in the short time period provided by Congress. We appreciate your consideration of our comments and would be pleased to work with you to clarify our letter or provide additional information. Please do not hesitate to contact us if we may be of assistance.

Sincerely,

David G. Tittsworth
Executive Director

Cc: The Honorable Arthur Levitt
The Honorable Norman S. Johnson
The Honorable Isaac C. Hunt, Jr.
The Honorable Laura S. Unger
The Honorable Paul R. Carey
Paul F. Roye, Esq.

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29 *See* March 27, 2000 letter from Karen L. Barr, ICAA General Counsel to Jonathan G. Katz, Secretary, SEC, re: Release No. 33-7808, File No. S7-08-00, Annual Conference on Uniformity of Securities Laws.

Pay-to-Play
and the
Investment Advisory Profession

In the last several years, there has been increased media and regulatory attention on pay-to-play abuses in the financial services industry. As used in this report, "pay-to-play" refers to political contributions by investment advisers made for the purpose of obtaining or retaining advisory contracts with government entities. In 1999, the Securities and Exchange Commission proposed regulations to prevent pay-to-play practices by investment advisers through, in essence, a prohibition on certain political contributions by broad categories of advisory personnel to broad categories of public officials, subject to draconian sanctions.

The ICAA has studied the possibility of voluntary professional measures designed to address pay-to-play practices. As a result of that study, the ICAA has developed suggested best practices to provide guidance on appropriate policies and procedures that are reasonably designed to prevent and detect pay-to-play abuses by firm personnel. We strongly suggest that ICAA member firms incorporate these or other appropriate policies and procedures into their codes of ethics.

At the same time, we have requested the SEC to consider issuing a rule in lieu of its current proposal that would require investment advisers having or seeking state and local government clients to adopt policies and procedures that are reasonably designed to prevent pay-to-play abuses. Additionally, we have strongly suggested that the Commission consider issuing a rule that would require all federally registered investment advisers to adopt a code of ethics. This "code of ethics" approach was first raised by two subcommittees of the American Bar Association in a comment letter on the proposed rule.[1] As discussed below, we believe our alternative approach is better suited to the investment advisory profession than the proposed rule and is consistent with other industry initiatives in this area.[2]

INTRODUCTION AND BACKGROUND

The Securities and Exchange Commission began studying pay-to-play practices in 1993 in the context of the municipal securities market. In response to that study, the Commission approved Municipal Securities Rulemaking Board Rule G-37 in 1994 to prevent broker-dealer participation in pay-to-play practices in the municipal securities business. Rule G-37 generally prohibits broker-dealers from engaging in municipal

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[1] Comment letter of ABA Committee on Federal Regulation of Securities, Subcommittee on Investment Companies and Investment Advisers, and Subcommittee on Private Investment Entities, re: Proposed Rule 206(4)-5 and Proposed Amendments to Rule 204-2 under the Investment Advisers Act of 1940 Regarding "Pay-to-Play" Practices (Jan. 5, 2000), attached at Appendix A; *see also* Legg Mason comment letter re: Release IA-1812, File No. S7-19-99 Political Contributions by Certain Investment Advisers (Nov. 1, 1999) at 5 (suggesting rule requiring advisers to adopt policies and procedures reasonably designed to detect and prevent illegal contributions).

[2] *E.g.*, American Bar Association Model Rules of Professional Conduct, Rule 7.6 (adopted Feb. 14, 2000), attached at Appendix B; *SEC Chairman Praises American Bar Association for Banning Lawyer Pay-to-Play*, SEC Press Release 2000-10 (Feb. 14, 2000); *Levitt Praises Independent Financial Advisers for Adopting Voluntary Pay-to-Play Ban*, SEC Press Release 99-25 (March 1, 1999); *Code of Ethics Solution to Pay-to-Play Under Consideration at SEC*, Fund Action (Feb. 7, 2000).

securities business with a government issuer for two years after the firm or certain employees make a political contribution to an official of the issuer who can influence the selection of the broker-dealer.

In the last few years, the Commission has turned its attention to pay-to-play activities involving public pension plans. The Commission has expressed concern that the selection of investment advisers by such plans has been or could be influenced by political contributions to certain officials. As a result, in August 1999, the SEC issued a proposed rule under the Investment Advisers Act of 1940 to prevent federally registered investment advisers and certain advisers exempt from registration from making political contributions intended to influence the award by public officials of advisory contracts for government entities.[3]

The proposed rule, modeled closely on Municipal Securities Rulemaking Board Rule G-37, would prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or any of its partners, executive officers or solicitors make a contribution to certain officials associated with the client. The proposed rule would cover a very broad group of advisory related personnel, government officials, and political candidates. The proposed rule would also amend Rule 204-2 of the Investment Advisers Act to require registered investment advisers to

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[3] *Political Contributions by Certain Investment Advisers*, Release No. IA-1812, File No. S7-19-99, 64 Fed. Reg. 43,556 (August 4, 1999).

maintain detailed records of political contributions made by the adviser, its partners, executive officers, and solicitors.

We previously submitted a detailed comment letter to the Commission concerning the proposed rule.[4] As emphasized in that letter, the ICAA condemns the practice of investment advisers or their employees making political contributions intended to influence the selection or retention of advisers by government entities because it undermines the principle that advisers are selected on the basis of competence, qualifications, expertise, and experience. Other commenters also agreed that making political contributions in order to buy business would be unethical and may undermine the integrity of the public pension plan system. We therefore understand and agree with the Commission's stated goal to eliminate and prevent pay-to-play abuses.

However, as indicated in our comment letter, the ICAA has serious concerns with many aspects of the proposed rule. The Commission received more than 50 comment letters from a wide variety of sources on the proposed rule and most of these letters raise significant objections to the proposal. Most commenters considered the proposed rule to be flawed in several major respects. Commenters raised serious constitutional issues, as well as concerns that the evidence of abuse was not demonstrated, that the penalty imposed was too harsh and inflexible, that the coverage of the rule was too broad, that current federal, state, and local laws adequately address the issue, and that compliance would be difficult, costly, and burdensome.

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[4] *See* November 1, 1999 letter from ICAA Executive Director David G. Tittsworth to Jonathan G. Katz, Secretary, Securities and Exchange Commission, attached at Appendix C.

As set forth below, we believe our voluntary standards address many of these concerns, while preserving the goal of preventing pay-to-play abuses. Following is our analysis of relevant issues and our recommendations to investment advisory firms.

First, we explain the differences between the investment advisory profession and the municipal securities business that make a Rule G-37 approach inappropriate and unworkable for investment advisers. Second, we discuss a suggested "policies and procedures" approach to pay-to-play, including the benefits of this approach. And finally, we set forth the ICAA's best practices guidelines for policies and procedures relating to pay-to-play for advisers' codes of ethics.

I. *Differences Between the Investment Advisory Profession and the Municipal Securities Business*

There are significant differences between the investment advisory profession and the municipal securities industry. These differences necessitate a markedly different approach for advisers from the regulatory regime established under MSRB Rule G-37.[5]

The principal difference is that, unlike municipal dealers, investment advisers have a *fiduciary* relationship with each of their clients, including pension plan and other government clients. In these relationships, the plan or entity itself is the client of the

[5] The vast majority of comment letters filed with the SEC on its proposed rule echoed this conclusion.

adviser, *not* the plan fiduciary, officials, or the plan's board members. Additionally, the investment adviser/client relationship is predicated on providing continuous and ongoing independent investment advice, whereas the municipal security business is transaction-oriented.

The process for obtaining public pension plan business differs significantly from municipal bond transactions. Unlike the municipal bond business where one official (often the treasurer) has significant influence over the award of a contract, the public pension process generally is more open and involves more decision-makers, including representatives of plan participants and consultants.[6] For example, CalPERS has noted that its Board has 13 members, including representatives of plan participants, certain elected officials, appointees of the governor and the legislature, and others.[7] Thus, there is less opportunity for one official who receives contributions to influence the selection of an adviser.

In addition to being more open, the bidding process for investment advisory contracts is more competitive and objective than in the municipal securities business.

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[6] Even in the few jurisdictions where control is not dispersed, questions remain about the virtue of pay-to-play restrictions. For example, the treasurer of Connecticut is vested with authority to make final decisions regarding pension plan advisory services. *See The Toughest Job in Pensions*, Institutional Investor (February 2000) at 58 (a larger board of trustees who jointly make decisions "is common in almost every other state"). Connecticut has enacted one of the nation's strictest state statutes prohibiting pay-to-play – perhaps stricter than the SEC's proposal. Conn. Gen. Stat. Section 9-333o (1997). In spite of this rule, a pay-to-play abuse occurred, prompting the current treasurer (who uncovered the scheme) to opine "[i]f someone really wants to commit a crime, you're not going to be able to stop them." *Id.* at 64.

[7] CalPERS comment letter re: Proposed Rule on Political Contributions by Certain Investment Advisers (Nov. 1, 1999) at 2. *See also* MOSERS (Missouri State Employees' Retirement System) comment letter re: Proposed Rules on Pay to Play (File No. S7-19-99) (August 17, 1999); SEC Release IA-1812 at 11.

Pension plan clients usually base decisions on objective criteria such as performance records and investment styles and strategies. In contrast to pension plans' open, objective style, the municipal securities business selection criteria are more subjective and negotiated underwritings account for the vast majority of long-term municipal offerings.[8] Another notable factor in the bidding process is that public pension plan clients, in their requests for proposals, frequently ask advisers bidding for advisory contracts to disclose contributions made in connection with soliciting or maintaining the business.[9] We have found no evidence that similar requests are made in the municipal securities contract process or were made at the time Rule G-37 was proposed.

There are also significant differences between Rule G-37 and the SEC's proposed rule in the number of affected employees and the degree to which such employees are centralized within firms. Covered employees of a firm reporting under Rule G-37 often are centralized in one department dedicated to the municipal securities business, while employees of an advisory firm who might solicit public pension plan business are more dispersed throughout advisory firms with various organizational structures.[10] The potential number of employees affected by the proposed rule is dramatically higher than those who are affected by Rule G-37. Varying advisory firm structures do not lend

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8 *See* comment letter of American Express Asset Management Group re: Pay-to-Play Comments File No. S&-19-99 (Oct. 29, 1999) at 3; comment letter of T. Rowe Price Associates, Inc. re: Political Contributions by Certain Investment Advisers; Release No. IA-1812; File No. S7-19-99 (Oct. 28, 1999) at 3 (citing SEC Release No. 24-33868 (April 12, 1994). *Indeed, MSRB G-37 does not apply to competitive municipal offerings.*

9 T. Rowe Price comment letter at p. 3.

10 *See* SIA comment letter re: Proposed Rule 206(4)-5 – File No. S7-19-99 (Oct. 29, 1999), at 2.

themselves to rigid definitions but rather require a more flexible approach, such as the approach discussed below.[11]

Due to the ongoing fiduciary obligations of an adviser – as opposed to the transaction-oriented nature of the municipal securities business – the proposed rule's sanctions for violations are inappropriate and may have undesirable consequences for public pension plan clients and beneficiaries thereof. The potential ramifications of a Rule G-37-type ban for investment advisers could be extremely disruptive to the client, and ultimately to the beneficiaries of the plan, even for minor violations that have nothing to do with pay-to-play abuses. Termination of a longstanding, ongoing fiduciary relationship is a much harsher result for both client and adviser than a time-out on new transactional business. Indeed, the penalty for violating the proposed rule is tantamount to a death penalty for an advisory relationship. It is extremely unlikely that a public pension plan would endure the hardships and disruptions created by a violation of the rule, go through the process of identifying and hiring a replacement adviser, and then return to the original adviser after the two-year ban ends. In all likelihood, the so-called "two-year ban" would operate as a *de facto* permanent ban. The same cannot be said in the municipal finance context.

Importantly, the record before the Commission regarding the number and extent of state and local laws and regulations governing pay-to-play activities related to investment advisers and public pension plans bears no resemblance to the evidence that

[11] We understand that similar considerations led the Commission to adopt a flexible code of ethics approach in the personal trading area under the Investment Company Act.

existed several years ago regarding pay-to-play activities in the municipal securities industry. When Rule G-37 was being considered, there were few state and local laws addressing political contributions to public officials who could influence the award of municipal securities business. In sharp contrast, today there is a multitude of state and local laws regulating pay-to-play activities of investment advisers and public pension plans. A large number of public retirement systems also have adopted written ethical standards to address any abuses.[12] The record before the Commission regarding the manner in which potential pay-to-play abuses in the investment advisory profession are currently covered by state and local laws and regulations, as well as direct evidence that indicates widespread abuses, is far different than the evidence that led to the promulgation of Rule G-37.[13]

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12 *See, e.g., Systems Who Have Adopted Written Ethics Standards, Either by Statute or Policy, Which Apply to the Retirement Board/Trustees*, Public Pension Coordinating Council 1997 Survey of State and Local Government Employee Retirement Systems.

13 The ABA subcommittees noted that:

> "MSRB Rule G-37 was the culmination of approximately four years of study and consultation with significant members of the municipal securities industry and bar, a process that began with the MSRB review initiatives of 1990, ultimately leading to two reports, one an MSRB report, *Report of the MSRB on Regulation of the Municipal Securities Market*, and the other a Commission staff report, *Securities and Exchange Commission Staff Report on the Municipal Securities Market*, Sept. 1993. Shortly after the publication of a draft of MSRB Rule G-37, hearings were held before Congress," describing the abuses existing in the municipal securities industry. ABA subcommittees comment letter at n. 2.

Similarly, the comment letter from the National Conference of State Legislatures notes that "[t]he SEC has failed to demonstrate, through empirical data, evidence of problems in the market that would necessitate federal rulemaking in the practice of pay-to-play" and that "[i]n issuing the proposed regulations the SEC has failed to defer, or even consider, state law and rulemaking regarding contributions to state and local officials and state and local campaign rule making." November 1, 1999 letter from Rep. Tim Ford and Rep. Robert Junell to Jonthan G. Katz, Secretary, Securities and Exchange Commission.

Unlike the municipal securities area, many state pension laws subject public pension plan officials to strict fiduciary and ethical restrictions.[14] Such restrictions would be violated if government officials selected an unqualified adviser based on political contributions instead of merit. As the ABA subcommittees have noted, these "statutes would appear to regulate more directly the problems created by pay-to-play practices by prohibiting state and local officials from using state business as leverage to extract campaign contributions."[15]

Because of these distinctions between the investment advisory profession and the municipal securities business, MSRB Rule G-37 does not provide an appropriate structure for addressing pay-to-play problems in the award of advisory contracts by public pension plans. Given the significant differences between the investment advisory profession and the municipal securities industry (including differences in legal and regulatory responsibilities), as well as the tremendous diversity among investment advisers, we believe that additional flexibility is both necessary and desirable to allow advisers to construct appropriate and meaningful policies and procedures on pay-to-play.

II. *An Alternative Approach to the Current Proposal*

To tailor a pay-to-play provision more effectively to investment advisers and to make other constructive rule changes under the Advisers Act, we have recommended to

[14] *See* ABA Subcommittees comment letter at n.19. Many of these state laws governing public pension funds "impose prudence standards and restrictions similar to those found in ERISA." Lemke & Lins, *Regulation of Investment Advisers* (1999) at 2-119.

[15] *Id.*

the Commission an alternative approach along the lines of the ABA Subcommittees' suggestion. We believe the Commission could issue a rule that requires certain investment advisers to adopt policies and procedures reasonably designed to prevent pay-to-play abuses by the firm or its employees.[16] The Commission should define pay-to-play as the practice of an investment adviser or its employees giving political contributions[17] *for the purpose of* obtaining the award or retention of investment advisory contracts by government entities.[18] The Commission obviously would retain its current authority under existing anti-fraud statutes, sections 206(1) and 206(2) of the Advisers Act, to pursue enforcement actions against investment advisers that engaged in pay-to-play abuses.[19]

Ideally, a firm's policies and procedures should be part of its code of ethics. Even though it is not a formal requirement today, we understand that the Commission's inspection staff typically requests such codes from non-mutual fund advisers during inspections, and that many such advisers have adopted codes of ethics. Indeed, in 1995, following the Investment Company Institute's report on personal trading, the ICAA

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[16] A firm that does not have or seek to have government entity clients clearly does not need to have pay-to-play policies and procedures. We recommend, however, that all advisers adopt codes of ethics, whether or not the code includes pay-to-play policies and procedures.

[17] We urge the Commission to confirm the interpretation of the proposed definition of "contribution" set forth in the ICAA comment letter, *supra* n.4, at p. 8.

[18] In its resolution addressing pay-to-play, the American Bar Association explains that "contributions are *for the purpose of* obtaining or being considered for a[n] … engagement … if, *but for* the desire to be considered for the" engagement, the attorney would not have made the contribution. *See* American Bar Association Model Rule 7.6, *supra* n. 2 (emphasis added). We urge the Commission to adopt this definition.

[19] The Commission already has determined that certain pay-to-play abuses are "inconsistent with the high standards of ethical conduct required of fiduciaries under the Advisers Act." Release at 19.

issued similar guidelines, which recommended that each investment adviser (including those to whom Rule 17j-1 does not apply) adopt a written code of ethics to address personal trading, use of inside information, gifts, and other situations where a possibility exists for conflicts of interest.[20] The letter accompanying those guidelines noted that many member firms already had developed such codes, consistent with the ICAA *Standards of Practice*. We continue to believe that all advisers should adopt codes of ethics.

To establish policies and procedures reasonably designed to prevent pay-to-play abuses, a firm would adopt a general prohibition against pay-to-play, applicable to all employees. This general prohibition may be accompanied by more narrowly tailored provisions requiring reporting, pre-clearance, record-keeping, or other measures reasonably designed to prevent pay-to-play practices. We have suggested such provisions in our guidelines, discussed below. These provisions may vary depending on the unique characteristics and business structure of each adviser. Firms also would monitor compliance with the requirements of these policies, determining appropriate responses to any covered employee's failure to comply with his or her ethical requirements. Most investment advisers already have a great deal of experience with pre-clearance, monitoring, disclosure, and record-keeping procedures relating to personal trading.

This approach to pay-to-play is desirable for a number of reasons.

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20 *See* ICAA Guidelines on Personal Investing, attached at Appendix D.

First, for better or worse, the Commission's jurisdiction is limited. *Any* rule that seeks to curb pay-to-play abuses by investment advisers can at best only serve as one component of a much larger web of other laws and activities – including enforcement of various campaign finance laws – designed to prevent similar abuses by public officials, consultants, and other persons who may be involved in influencing decisions to hire or retain investment advisers, broker-dealers, custodians, lawyers, and other providers by a public pension plan. Many commenters expressed concern that the proposed rule would affect only a subset of persons providing investment advisory services to government entities, not to mention firms providing other financial services.[21] Other commenters requested the Commission to clarify its proposal to exclude them from its scope.[22] As Chairman Levitt has noted, the SEC ". . . can only do so much. At the end of the day, the responsibility for maintaining investor confidence rests heavily on the shoulders of market participants . . . ."[23]

[21] *E.g.* ABA Subcommittees comment letter; AIMR comment letter; ICAA comment letter; SIA comment letter. To hold the entire investment advisory profession to a high standard of integrity, we also encourage investment advisers that are not registered with the Commission, such as hedge fund advisers and state-registered advisers, to adopt guidelines prohibiting pay-to-play abuses.

[22] For example, some commenters urged that the proposed rule be limited to persons who provide "advisory services" such that they are deemed "investment advisers" under the Investment Advisers Act of 1940. One commenter noted that this would exempt from the rule broker-dealers who provide advisory services to public pension plans that are "solely incidental" to brokerage services. Morgan Stanley Dean Witter Management Inc. comment letter re: Proposed Rule 206(4)-5 – File No. S7-19-99 (Nov. 1, 1999) at section VI; *see also* SIA comment letter. This highlights further implications of the Commission's Release No. IA-1845 (Certain Broker-Dealers Deemed Not to Be Investment Advisers). Under the Commission's proposal, broker-dealers who provide non-discretionary advisory services to public pension plans would be exempt from the definition of "investment adviser" under section 202 of the Advisers Act and therefore would not be subject to any pay-to-play regulations under the Act.

[23] SEC Press Release No. 2000-10, *SEC Chairman Praises American Bar Association for Banning Lawyer Pay-to-Play* (Feb. 14, 2000).

Second, we believe our recommended alternative approach is consistent with constitutional principles (and relevant judicial decisions) that generally favor an individual's ability to participate in the political process. Pursuant to these principles, government regulation of political contributions must be narrowly tailored to advance the compelling government interests asserted.[24] A government requirement of policies and procedures designed to address pay-to-play would not likely be held an unconstitutional infringement on First Amendment protections; the responsibility of tailoring policies and procedures would be placed on firms rather than the government. In particular, a rule reaching conduct that is *for the purpose of buying* business is more narrowly tailored to meet the Commission's objective of eliminating such practices than is the current proposal. The American Bar Association recently followed a similar approach in its resolution prohibiting political contributions made "for the purpose of obtaining or being considered for" government engagements.[25]

Third, our alternative approach is consistent with the Federal Election Campaign Act of 1971.[26] Based on the First Amendment and federal regulatory implications of the Commission's proposal for federal campaigns, we suggest that the Commission's proposal not apply to candidates for federal office. Further, while a firm's general policy statement prohibiting political contributions made *for the purpose of* obtaining or

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[24] *See Blount v. Securities and Exchange Commission*, 61 F.3d 938, 943 (D.C. Cir. 1995); *see also Nixon v. Shrink Missouri Government PAC, et al.*, 120 S. Ct. 897 (2000) (affirming principles of *Buckley v. Valeo*, 424 U.S. 1 (1976)).

[25] American Bar Association Model Rule 7.6, *supra* n.2; *see also* SEC Press Release No. 2000-10, *SEC Chairman Praises American Bar Association for Banning Lawyer Pay-to-Play* (Feb. 14, 2000).

[26] *See* ICAA comment letter, *supra* n.4, at p. 9 (discussing conflicts between the proposed rule and FECA, as well as policy implications of the proposal for federal campaigns).

retaining government relationships should apply to officials and candidates at all levels, we suggest that firms' more specific procedures may reasonably apply only to officials and candidates at the state and local level.

Fourth, our suggested alternative is consistent with the Investment Advisers Act and other federal securities laws, particularly because it emphasizes the appropriate role of disclosure and related procedures in addressing potential problems rather than imposing a proscriptive, one-size-fits-all rule. Traditionally and historically, the Commission has employed disclosure as the primary means of addressing conflicts of interest. For example, firms are not prohibited from using soft dollars, from "bunching" client trades together in block orders or from selecting brokers using reasonable criteria. Similarly, firm personnel are not prohibited from engaging in personal investing. Instead, firms are required or encouraged to establish reasonable policies and procedures to prevent potential abuses in these areas, to disclose potential conflicts of interest, and to maintain certain records. Increasingly, the Commission has been moving away from technical regulation to a more flexible approach.[27] Thus, a reporting and record-keeping regime for pay-to-play is more consistent with the Investment Advisers Act and other securities laws than is a flat, broad prohibition accompanied by detailed "command-and-control" requirements.

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[27] For example, the Commission recently replaced its detailed regulation of performance fee arrangements with a more flexible approach that acknowledges the ability of advisers and their sophisticated clients to negotiate varying agreements best suited to their relationships. *See* SEC Release No. IA-1731 (July 15, 1998).

Fifth, the suggested approach takes into consideration the significant evidence that state and local laws and regulations are working to curb pay-to-play abuses in cases involving public pension plans, unlike the evidence that existed in the municipal securities area earlier this decade. In the time since Rule G-37 was released, many state and local governments have mandated restrictions or disclosures designed to deter pay-to-play practices. According to our members, many investment advisers already have policies and procedures in place to report contributions under state and local law and to avoid pay-to-play issues. Further, some clients request investment advisers to disclose contributions during the bidding process. Given the laws and procedures that are in place, a code of ethics approach is more appropriate than a Rule G-37 approach.

Sixth, our suggested approach would take the Commission and its staff out of the onerous business of considering exemption requests. Under the current proposal, it is likely that the staff would be inundated with requests for exemptions based both on inadvertent violations and on the desire of advisory personnel to make contributions based on political, religious or other reasons not related to obtaining government business. It is in the public interest that the Commission's limited resources be dedicated to fighting demonstrable problems such as internet fraud, rather than responding to myriad exemption requests.[28]

[28] We understand that the staff of the Division of Investment Management is already flooded with exemption requests under various existing regulations permitting exemptions. *See, e.g.*, SEC News Digests, March 20-31, 2000, Issues 2000-52 through 2000- 61 (during a two-week period, the Division of Investment Management issued notices and granted exemptions under sections 2(a)(9), 3(b), 6(b), (c) & (e), 7(d), 12(d), 15(a), 17(a), (b), (d) & (e), 26(b), and 61(a) of the Investment Company Act).

Finally, our suggested approach would achieve the extremely positive result of encouraging the adoption of codes of ethics by *all* investment advisers. We believe that such a result – in and of itself – would leave a lasting legacy on investor protection.

III. *Best Practice Guidelines for Adviser Codes of Ethics*

The Investment Counsel Association of America has worked with its members to suggest potential policies and procedures that could be included in an investment adviser's code of ethics to prevent and detect any pay-to-play abuses. Our suggested guidelines for an adviser's code of ethics follow:

General Guidelines for SEC-Registered Investment Advisers

A. In 1995, the ICAA encouraged its member firms to adopt a Code of Ethics that would address, among other things, personal trading, gifts, the prohibition against the use of inside information, and other situations where there is a possibility for conflicts of interest.

B. Since that time, the vast majority of ICAA member firms have adopted such a Code of Ethics.

C. The ICAA recommends that any investment adviser that provides investment supervisory services to government entities, or that seeks to provide such services, include in its Code of Ethics a broad prohibition against making political contributions for the purpose of obtaining or retaining advisory contracts with government entities ("pay-to-play").

D. The ICAA recommends that any investment adviser that provides investment supervisory services to government entities, or that seeks to provide such services, adopt policies and procedures reasonably designed to prevent pay-to-play abuses by the investment adviser and its employees.

E. The ICAA recommends that such policies and procedures be tailored to the investment adviser's specific circumstances, including, for example, the number of government clients the adviser advises, the amount of revenue derived from government business, the number and type of employees who have significant responsibilities and contact with government clients, the adviser's marketing efforts with respect to such clients, the firm structure as it relates to the public pension plan and other public entity business, relevant state and local laws and regulations, and other appropriate considerations.

F. The ICAA recommends that an investment adviser be mindful of constitutional issues related to pay-to-play, including an employee's right to make political contributions based on personal, religious, or political reasons. For example, a policy could be tailored permissibly to exclude from its scope contributions to candidates for federal office or could exclude contributions to officials of public entities that select advisers based on objective criteria and a competitive bidding process. A policy could also exclude contributions to organizations not controlled by the employee, firm, or particular candidate, such as groups supporting minority or female candidates or candidates with certain political positions.

Policies and Procedures Reasonably Designed to Prevent Pay-to-Play Abuses by the Firm and its Employees

The ICAA suggests the following potential compliance procedures, which should be tailored to the adviser's specific circumstances:

A. *Certification of Compliance with Codes of Ethics.* As recommended in 1995 in connection with the ICAA Guidelines on Personal Investing, an adviser's employees should annually certify that they have read, understood, and complied with the firm's Code of Ethics. As part of this certification, employees should also certify that they have not made any political contributions for the purpose of obtaining or retaining the firm's engagement as an investment adviser to a government entity.

B. *Restrictions on Political Contributions.* To prevent pay-to-play abuses, the following alternative approaches are suggested. An adviser could combine aspects of these approaches or develop other equally reasonable approaches:

1. <u>Contribution Ban.</u> An investment adviser may choose to prohibit all or certain of its employees from making political contributions above a certain *de minimis* amount to any person who may influence the selection or retention of an investment adviser by a government entity.

Comment

a. If such an option is approved, the adviser should implement appropriate policies and procedures that reasonably ensure – on a periodic basis – that each employee to whom the prohibition applies is aware of the adviser's policies and procedures, understands them, and agrees to comply with them.

b. Each firm should choose a *de minimis* amount based on its unique facts and circumstances, including the magnitude and type of its government entity business and any applicable state or local law. The firm could decide whether the *de minimis* standard applies to all contributions or is limited to some subset of contributions to officials or candidates.

2. Pre-Clearance. An investment adviser may prohibit contributions by all or certain of its employees in a manner similar to (1) above, unless otherwise pre-cleared with compliance or legal personnel. An employee seeking pre-clearance should certify that the contribution is not made for the purpose of obtaining or retaining the firm's engagement as an investment adviser by the government entity.

3. Disclosure to Clients. An investment adviser may establish an effective system to disclose or offer to disclose any and all firm and employee contribution information material to its current and prospective government clients.

Comment

a. If this approach is used, the disclosure should be made initially at the time the adviser proposes to be retained by the prospective client. If selected by the client, the adviser should make additional disclosure at the time of selection and then periodically thereafter.

b. A committee of senior personnel or the compliance officer should review employee political contribution reports for conflicts of interest or abusive practices, as set forth below in section D.

C. *Reporting of Political Contributions.* Codes of Ethics should establish reporting regimens appropriate to the conceptual approach taken (*i.e.* ban, pre-clearance, disclosure, or other). A firm that establishes a ban on contributions may require only annual certification of compliance with the ban. Firms taking a pre-clearance or disclosure approach may require certain employees to report to the firm their political contributions at the state and local level on a periodic basis or when they occur, or certify that no such contributions were made. A new covered employee should also disclose such political contributions from the time he or she entered into employment negotiations with the adviser.

Comment

1. This reporting policy should be designed to elicit reports from personnel likely to be significantly involved in soliciting government business. The coverage of the policy should be tailored to the structure of each firm. At smaller firms, all officers or solicitors may have substantial involvement in government entity solicitation or marketing.

At mid-sized or larger firms, the universe may need to be defined more narrowly.

2. The policy may require reports of all contributions, contributions in excess of a certain *de minimis* amount, or only contributions (all or in excess of a *de minimis*) to persons who are in a position to influence the selection or retention of the adviser by government entities.

3. Reports by employees should include appropriate details regarding the jurisdiction in which the candidate is seeking public office and the position that the official or candidate holds or is seeking.

4. Each report could include a certification that no contribution was made for the purpose of obtaining or retaining the firm's engagement as an investment adviser to government clients.

5. The policy should include measures to ensure that the reports are kept confidential.

D. *Monitoring of Political Contribution Disclosure*. Where applicable, firm procedures should include review of political contribution reports in light of the firm's government clients, any pattern of contributions by a particular employee or group of employees, and other relevant factors. The review may include any known external information, such as public contribution reports required by local law in relevant jurisdictions.

E. *Record-Keeping.* Depending on the approach taken, an investment adviser should maintain required records of political contributions and a list (compiled at least annually) of the firm's government clients. For example, an adviser should maintain records of the pre-clearance process if the pre-clearance approach is chosen.

F. *Sanctions for Violations of Code of Ethics Provisions*. An adviser's Code of Ethics should include appropriate sanctions and/or remedies for violations of the adviser's pay-to-play policies and procedures. In this regard, the adviser should consider all relevant facts and circumstances, including whether the violation was inadvertent, any pattern or practice of violations, the size of the contribution, the influence of the official, and any harm caused. These sanctions or remedies could include:

1. Internal actions, based on the various facts and circumstances, including letter of reprimand, fines donated to charity, suspension or termination of the employee.

2. Disclosure to client and/or independent representatives of the client, where appropriate.

We emphasize that our guidelines are not intended to dictate the content of any firm's Code of Ethics. Policies and procedures adopted by an investment adviser should be tailored to meet the facts and circumstances of each adviser. An adviser's policies and procedures may vary depending upon consideration of appropriate factors.

CONCLUSION

The ICAA strongly opposes any practice by which investment professionals try to gain access to business through political contributions. In suggesting our guidelines, we have attempted to address pay-to-play practices without unnecessarily infringing on free speech rights or imposing unnecessary burdens on the investment advisory profession. We hope that this report will prove responsive to the Commission and Congress as they consider the issue of pay-to-play in the context of public pension plans. More important, we trust that our recommendations will provide important safeguards that will help to ensure the integrity of the public pension plan system and the investment advisory profession.

May 15, 2000

Statement of

David G. Tittsworth
Executive Director
Investment Counsel Association of America, Inc.

SEC Roundtable on Investment Adviser Regulatory Issues

May 23, 2000

The Investment Counsel Association of America, Inc.[1] greatly appreciates the opportunity to appear before the Commission today to address several important issues and developments affecting the investment advisory profession.

We commend the Commission for convening this historic roundtable. The amount and pace of change occurring in the investment advisory profession – and in regulations governing the profession – is unprecedented. In light of the mega-trends that are reshaping the profession, the ICAA believes it is both timely and appropriate for the Commission to take a step back and assess the state of investment adviser regulation. In doing so, the Commission faces the basic issue of considering whether the current statutory and regulatory regime is effective and efficient in terms of its primary missions of protecting investors and maintaining fair and orderly markets.

Background and History of Investment Adviser Regulation

Federal regulation of the investment advisory profession commenced with the passage of the Investment Advisers Act in 1940.[2] The profession itself was relatively new at the time, having evolved earlier in the century:

> The growth in investment counselors prior to the enactment of the Advisers Act was due, in part, to the increase in the number and complexities of securities, and interest among investors in obtaining competent and unbiased guidance regarding the management of their investments. The losses suffered by investors during the depression years caused many public investors to seek continuous supervision and advice concerning their investments. A new breed of "investment counsel" emerged to meet this need for unbiased information and guidance. These new

[1] The ICAA is a not-for-profit trade association that exclusively represents the interests of federally registered investment advisory firms. Founded in 1937, the ICAA's membership today is comprised of more than 250 firms that collectively manage in excess of $2 trillion for a wide variety of institutional and individual clients. For more information, please see www.icaa.org.
[2] Public Law No. 76-768, 54 Stat. 847.

professionals were distinguished from others in the securities field by two fundamental principles. First, these professionals limited their actions to providing unbiased advice and did not engage in any other activity, such as selling securities or acting as broker-dealers, which might directly or indirectly bias their investment judgment. Second, their compensation for this work consisted solely of definite, professional fees, fully disclosed in advance. The name "investment counsel," then not widely in use, was selected to describe both the work based on these two principles and the persons engaged in that work.[3]

The Advisers Act was enacted following a report from the Commission[4] and subsequent hearings by the Congress on investment trusts, investment companies, and investment advisers. It was the last in a series of federal laws designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's.[5] The law was relatively modest in scope. At its core was a requirement that all investment advisers register with the Commission by filing an application containing specific information about the firm and persons who provided investment advice. "Investment adviser" was defined as a person who (1) for compensation (2) is engaged in the business (3) of providing advice to others or issuing reports or analyses regarding securities.[6] The current law also contains various anti-fraud provisions that prohibit or limit certain activities, including severe restrictions on transactions where the adviser acts as principal.

The ICAA was formed in 1937. Our organization played an active role in the development of the Advisers Act.[7] Since its inception, the ICAA has always prescribed certain principles of conduct for its member firms in the practice of their profession. Over the years, many of these principles have been used by Congress and the Commission as the basis for legislation and regulations governing the conduct of investment advisers.[8] Testimony of the ICAA was also cited in the leading case of the

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[3] *"2000 and Beyond: SEC Priorities for the Investment Adviser Profession,"* speech by Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission before the ICAA (April 6, 2000).

[4] U.S. Securities and Exchange Commission, *Investment Trusts and Investment Companies* (1939).

[5] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, at 186 (1963).

[6] Section 202(a)(11), Investment Advisers Act of 1940. Importantly, the definition of investment adviser includes various exemptions from the law's requirements, including banks and broker-dealers.

[7] *See A Brief History of the Investment Counsel Association of America*, at pp. 33-39 (1982).

[8] Following are the current ICAA *Standards of Practice*, which are endorsed by all member firms of the ICAA: I. *Professional Responsibility.* An investment adviser is a fiduciary and has the responsibility to render professional, continuous, and unbiased investment advice oriented to the investment goals of each client. II. *Professional Qualifications.* To enable a member firm to serve its clientele effectively, its investment and managerial personnel should be individuals of experience, ability, and integrity. III. *Financial Responsibility.* A member firm should maintain capital and reserves adequate to provide the services for which it was retained. IV. *Compensation for Services.* Compensation of a member firm for investment advisory services should consist exclusively of direct charges to clients for services rendered and should not be contingent upon the number or value of transactions executed. V. *Promotional Activities.* The content in written and oral statements made by a member firm soliciting new clients should be consistent with the investment adviser's professional responsibility. VI. *Confidential Relationship.* Information concerning the identity of security holdings and financial circumstances of clients is confidential.

U.S. Supreme Court defining the standards of fiduciary conduct applicable to all investment advisers.[9] Through the years, our organization has supported appropriate regulation in order to protect investors and promote the integrity of the investment advisory profession.

Assessing the Current Legal and Regulatory Framework

The basic statutory framework of the Advisers Act is relatively simple and straightforward. Certain investment advisers are required to register with the SEC and are subject to regulations issued and enforced by the Commission.[10] The statute makes it unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client or prospective client," to engage in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and to engage in principal trades without receiving the consent of the client.[11] The law authorizes the Commission to promulgate rules and regulations that define and prescribe ways to prevent any act, practice, or course of business by an adviser that is "fraudulent, deceptive, or manipulative."[12] Consistent with the other major federal securities laws, the Advisers Act largely relies on full and fair disclosure to effectuate its purposes.

Investment advisers also are subject to a strict fiduciary duty. This duty has been upheld by the U.S. Supreme Court[13] and reiterated by the Commission in various pronouncements over the years.[14] This fiduciary duty is one of the primary distinctions between investment advisers and others in the financial services industry.[15] As a fiduciary, "an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions."[16] Among obligations that flow from an adviser's fiduciary

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9 *Supra*, fn. 5.
10 *See* Sections 203 and 209, Investment Advisers Act of 1940.
11 Section 206(1), (2), and (3), Investment Advisers Act of 1940.
12 Section 206(4), Investment Advisers Act of 1940. The Commission also is given authority to exempt persons or transactions from the Advisers Act or regulations thereunder, "to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." Section 206A, Investment Advisers Act of 1940.
13 *Supra*, fn. 5.
14 *See, e.g., In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948). "The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice 'in almost every instance.' This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients."
15 *Supra*, fn. 3, at p. 4.
16 Lemke & Lins, *Regulation of Investment Advisers*, at 2-34 (1999).

duty are: (1) the duty to have an adequate, reasonable basis for its investment advice; (2) the duty to obtain best execution for clients' securities transactions where the adviser directs such transactions; (3) the duty to render advice that is suitable to clients' needs, objectives, and financial circumstances; and (4) the duty to make full and fair disclosure to clients of all material facts, particularly regarding potential conflicts of interest.[17]

Thus, while the basic structure of the legal framework governing investment advisers is relatively uncomplicated, an adviser's legal obligations are rigorous and demanding. Disclosures required of advisers in registering with the SEC alone are without precedent in other regulated professions. Among numerous other matters, advisers are required to disclose the educational and business background of each person who determines general investment advice to clients (as well as executive officers), the adviser's basic fee schedule (including how fees are charged and whether such fees are negotiable), types of investments and methods of securities analysis used, how the adviser reviews client accounts, the adviser's other business activities, material financial arrangements the adviser has with a wide variety of entities, certain referral arrangements, and numerous other disclosures that describe activities that may pose potential conflicts of interest with the adviser's clients, including specific disclosures relating to trading and brokerage practices. Form ADV must be amended promptly to reflect material changes. An adviser is required to provide a brochure containing such information to prospective clients and offer updates at least annually to existing clients.[18] The Commission's recent proposed rules to revamp Form ADV are intended to make further improvements in disclosure and, once fully implemented, will result in significantly more – and much more readily available – information about specific advisers and the investment advisory profession than ever before.[19]

One can only imagine the howls of protests that would result if similar requirements were to be imposed on doctors, lawyers, broker-dealers, accountants, bankers, or other professionals. Requiring other professions to disclose their fees – in and of itself – would generate major lobbying efforts designed to keep the heavy hand of government from bringing down the American system of capitalism! Coupled with the applicable strict fiduciary duty, the legal and regulatory requirements for investment advisers comprise a formidable set of standards.

The ICAA believes the basic framework for the advisory profession has withstood the test of time. The primary purpose of the Advisers Act and related standards and regulations is to protect investors. *Apart from a relatively few isolated instances, there has never been a fundamental breakdown in investor protection in the 60 years since the Advisers Act was enacted.* Compared to other segments of the financial services industry, the advisory profession has maintained a stellar record – free of systemic abuses and prolific investor complaints.

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[17] *Id.*, at 2-35.

[18] Advisers Act Rule 204-3.

[19] In announcing the proposed rules, Chairman Levitt stated that the proposals "further the Commission's belief in full and fair disclosure as the bedrock upon which our securities laws are based." Opening Statement of Chairman Arthur Levitt, Amendments to Form ADV (April 5, 2000).

We also believe that any appropriate legal and regulatory regime for the advisory profession must be flexible enough to address the enormous diversity among advisers. Today, there are about 8,000 SEC-registered advisers. These advisers run the gamut from sole practitioners who may offer a single niche investment approach to a limited number of clients to firms with thousands of employees and offices in various countries that offer a variety of financial services and products to a diverse group of clients. There are obvious differences between how such firms conduct their business. Command-and-control requirements that seek to impose a one-size-fits-all solution for various legal and regulatory issues do not lend themselves to the widely divergent community of advisers. We thus believe that the current structure of the Advisers Act – and its reliance on disclosure and broad anti-fraud authority rather than specific and rigid regulatory requirements – is both appropriate and effective.

To our knowledge, the only major regulatory problem identified during the history of the Advisers Act has been the ability of the Commission to conduct appropriate oversight of the advisory profession. The immense growth in the number of registered investment advisers between 1980 and the mid-1990's outstripped the ability of the SEC to conduct regular inspections. As discussed below, we strongly believe that enactment of the Investment Advisers Supervision Coordination Act in 1996 solved this problem and, in fact, has resulted in a virtual revolution in adviser regulation accompanied by the prolific increase in inspection and enforcement activities by the Commission.

Given the dramatic changes occurring in the advisory profession, however, we believe the current legal and regulatory framework governing the advisory profession will be tested. Growth, consolidations, globalization, and technology are transforming the investment advisory profession and the financial services industry. Record growth in the industry is being fueled in the U.S. by a maturing generation of baby boomers and by wealth created from the longest bull market in history. Mergers and acquisitions are occurring in all segments of the industry. In the ICAA, for example, the number of firms that have merged with other firms or that are owned by other entities – insurance companies, banks, and holding companies – has escalated during the past few years. Globalization has helped to spurn the creation of mega-firms that are seeking to provide the full range of financial services to individuals and institutions around the world. And technology continues to transform the manner in and the price at which financial services are delivered, greatly increasing competition among all service providers and introducing new waves of increasingly diverse financial products and services. These and other developments are having a profound impact and may present significant challenges to the policy makers, regulators, and the advisory profession.

Self-Regulatory Organizations and the Advisory Profession

In 1989,[20] the Commission transmitted a legislative proposal to the Congress to provide for the establishment of one or more self-regulatory organizations for registered

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[20] Questions relating to the establishment of a self-regulatory organization for the investment advisory profession were raised well before 1989. For example, on June 11, 1962, the ICAA responded to a series

investment advisers.[21] In so doing, the Commission stated that "self-regulation of investment advisers under the Advisers Act through the creation of one or more self-regulatory organizations would permit the Commission and the investment adviser industry to achieve important regulatory objectives, and would provide increased investor protection at private, rather than public, cost."[22]

The impetus for the proposal was the tremendous growth of registered investment advisers – and corresponding increases in the number of advisory clients and assets under management – and the lack of adequate Commission resources to conduct effective oversight of the profession.[23] The ICAA supported the goal of more effective oversight of the advisory profession, but strongly opposed the SEC's legislative proposal:

> Consistent with its purpose and its past, the ICAA supports the SEC in its efforts to better regulate a growing and increasingly diverse industry. We recognize, as Senator Dodd says, that "there are thousands of individuals and firms that hold themselves out to be financial planners that are not registered with the SEC as investment advisers. . . ." We suspect that many of these advisers, who have not seen fit to comply with the critical first step of registration, pose a far greater risk of non-compliance than do the already registered advisers. Accordingly, we support increased effort by the SEC and the states to bring those unregistered advisers under regulation.
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> We also support the SEC's goal of improved inspection of investment advisers. The growing number of investment advisers and the increasingly complex and diverse nature of the industry require that improvement. It will help achieve the standards and the quality that the ICAA has always sought.
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> However, we believe that the goal is best achieved by strengthening the enforcement of existing SEC and state regulation, not by the addition of a new layer of self-regulation. We believe that the SEC, with its knowledge of the industry and its demonstrated capability is the appropriate body to do the job. Knowing the industry, we believe that increased scrutiny should come from an SEC staff that understands it, and has the experience necessary to set standards, administer them, and enforce them.
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> Self-regulation would introduce a host of unexplored problems. Unlike broker-dealers, advisers rarely transact business among themselves. Nor is there a common thread among advisers associated with broker-dealers, advisers who sell

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of questions from Milton H. Cohen, Director of the SEC's Special Study of the Securities Markets, which included a question as to whether the ICAA would consider it desirable in the public interest for the ICAA to "obtain official status as an industry self-governing body."

[21] *See* Letter from David S. Ruder, Chairman, U.S. Securities and Exchange Commission to The Honorable Dan Quayle, President of the U.S. Senate. (June 19, 1989).

[22] *Id.*.

[23] In 1980, there were 5,600 SEC-registered investment advisers. By 1990, the number had grown to more than 17,000. When the Coordination Act was enacted in 1996, the number of SEC-registered investment advisers was more than 22,500.

> product, financial planners, and investment counsel. There is, then, a significant question whether all of these very different types of advisers should be forced into a single self-regulatory organization and whether, if they are, that organization could fairly inspect and regulate them. There is also a significant economic question whether groups of advisers with common business practices can support separate self-regulatory bodies. And even if several separate SRO's can be supported, there remains the very difficult question of how to assure fairness and uniformity of inspection and regulation among them.
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> In our view, the problem is not one requiring a change of structure; rather, it is how to fund better inspection. We do not see any need to make a broad transfer of the SEC's regulatory authority to solve that problem. The very same increased fees that would fund self-regulation will fund the needed additions to the SEC's staff. . . . The increased expense that advisers would necessarily incur to fund an experiment in self-regulation can instead be used by the SEC to achieve the level of inspection that it seeks and that we support.[24]

The Commission's proposal to authorize the formation of self-regulatory organizations for the investment advisory profession died quickly. However, we remain concerned about renewed attempts to authorize the formation of SROs for the advisory profession.

Notably, NASD Regulation, Inc. (NASDR) has maintained a steady drumbeat calling for additional regulation of investment advisers.[25] Three years ago, for example, NASDR sent an extensive memorandum to SEC staff.[26] The memo states that the financial services industry is undergoing significant change, that services provided by brokers and advisers often bear close resemblance to each other, and that the "lack of clear and current regulatory standards will encourage firms to adopt subtle modifications to their activities in order to avoid the important requirements of the Securities Exchange Act of 1934" – the primary law regulating broker-dealers. The clear implication of the letter and accompanying memorandum is that, at a minimum, certain investment adviser practices should be regulated by NASDR. In September 1998, the chairman of NASD stated that his organization was collecting information to make a case for NASD regulation of investment adviser practices.[27] And last summer, NASDR's president

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[24] Letter from Charles E. Haldeman, Jr., President, Investment Counsel Association of America, Inc. to Senators Christopher J. Dodd and John Heinz (September 22, 1989).

[25] The NASD's interest in regulating investment advisers dates back at least to 1986 when it announced, during the SEC's May 7 roundtable on the securities industry, its support for a proposal for NASD to serve as an SRO of advisers that were members of NASD or affiliated with NASD members. As reported in the May 8, 1986 *Wall Street Journal*: "NASD leaders surprised a meeting of Securities and Exchange Commission officials and financial industry representatives when they disclosed that the NASD board had unanimously approved an experiment in investment adviser regulation."

[26] Letter from R. Clark Hooper, Senior Vice President, NASDR to Barry P. Barbash, Director, SEC Division of Investment Management and Dr. Richard R. Lindsey, Director, SEC Division of Market Regulation, and accompanying NASDR memorandum from Thomas M. Selman, Joseph E. Price, and Lawrence N. Kosciulek to R. Clark Hooper (December 8, 1997)

[27] *"Top NASD Officials Call For Adviser Regulation," IA Week* (October 19, 1998). The article cites a speech to the California Association of Independent Broker-Dealers by Frank Zarb, NASD Chairman,

denied that NASDR is in the market to become an SRO for the advisory profession, while expressing "concern" that brokers are fleeing their side of the securities business in order to become investment advisers, who she claimed are subject to "less regulation."[28]

We are also troubled by the fact that NASDR has been selected by the SEC and the North American Securities Administrators Association (NASAA) to administer the proposed Investment Adviser Registration Depository (IARD). We have consistently expressed our concerns about NASDR's involvement in this momentous undertaking.[29] We truly appreciate the repeated assurances by the Commission that NASDR's role will be limited to a contract operator of the system.[30] Nonetheless, we remain extremely wary of the fact that – by virtue of its central role in the IARD – NASDR will have direct access to and a certain amount of control over every aspect of the most comprehensive database on investment advisers ever created. We also have serious concerns that the IARD will in fact be a mere extension of the CRD that NASDR operates for broker-dealer and agent registration instead of a separate SEC-authorized system for investment advisers.

We continue to oppose the creation of a self-regulatory organization for the advisory profession. An investment adviser SRO is unwarranted and would impose a new layer of cost and bureaucracy on the profession. And the reasons that persuaded Congress to authorize the creation of an SRO for broker-dealers – the high level of interconnectivity between broker-dealers, the number of documented cases involving investor fraud, conflicts of interest, and overly aggressive sales practices, as well as the highly technical issues related to settlement, execution, and reconciliation involving broker-dealer transactions – simply do not exist in the investment advisory profession. NASDR seems to have its hands full in dealing with problems that exist at the core of the broker-dealer industry. Instead of worrying about extending its reach to another industry, it would do well to stick to its core mission of regulating the brokerage industry and to coordinate with the SEC and other regulators in addressing novel issues that may be created by changes occurring in financial services.

At the very minimum, it is certainly reasonable to suggest that the new regulatory regime created by the Coordination Act should be given more time before looking to Congress to consider a drastically different regulatory framework. Given the changes that have occurred in adviser regulation during the last three years, no one can now

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where he said that NASD is collecting information that will enable it to make a case to the SEC that the self-regulatory organization should have jurisdiction over investment advisers and includes the following quotation from Mr. Zarb: "I've had a conversation with [SEC Chairman] Arthur Levitt about the subject specifically, and we agreed that we are going to take a look at what kind of model we can put together where we can be delegated authority to . . . have some responsible reach over that part of the [investment] community."

28 *"Broker Exodus," IA Week* (May 24, 1999).

29 *See, e.g.*, Letter from ICAA Executive David G. Tittsworth to Barry P. Barbash, Director, SEC Division of Investment Management (September 23, 1998) (available on the ICAA web site, www.icaa.org, under "Comments and Statements").

30 *See* Opening Statement of Chairman Arthur Levitt, Amendments to Form ADV (April 5, 2000): "I want to be clear that NASDR will be operating in this venture as a contractor for us and not as a self-regulatory organization for investment advisers."

seriously argue that an adviser SRO is warranted because of the SEC's lax oversight of the industry.

The Investment Adviser Supervision Coordination Act

Historically, investment advisers have been subject to both federal regulation and to varying state laws and regulations. The ICAA views the scheme of dual federal and state regulation as unnecessary, burdensome, and ineffective. Many of our member firms that transact business in a large number of states have found that compliance with the wide array of state laws and regulations has been difficult and time-consuming without providing any concomitant increase in investor protection or effective oversight of the advisory profession. We therefore strongly supported efforts to develop legislation in order to eliminate duplicative and inconsistent state regulation of the profession.

Thanks in large measure to the efforts and leadership of Senators Gramm and Dodd, the Investment Advisers Supervision Coordination Act[31] was enacted in 1996. The Coordination Act represents the greatest change in the laws authorizing regulation of investment advisers since passage of the Investment Advisers Act in 1940. The primary dilemma Congress faced in revamping the Advisers Act was how to deal with a rapidly growing profession.

> [T]he bill creates a clear division of labor between the states and the federal government for supervision of investment advisers. Currently, while most investment advisers are nominally supervised by the SEC and most states, both are overwhelmed by the size of the task, with more than 22,000 investment advisers currently registered with the SEC. The reality has been that while investment advisers may boast of their registration with the SEC, the SEC has been unable to conduct active supervision of more than a fraction of the advisers registered with the Commission. State securities regulators have similarly found their resources spread thin. . . .
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> Today there are approximately 22,500 investment advisers registered with the Securities and Exchange Commission. The number of registered investment advisers has increased by over 500% since 1980, far outstripping the growth in the Commission's examination resources. As a result, smaller investment advisers are now examined, on average, once every 44 years – amounting to virtually no regulation at all. . . .
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> Recognizing the limited resources of both the Commission and the states, the Committee believes that eliminating overlapping regulatory responsibilities will allow the regulators to make the best use of their scarce resources to protect clients of investment advisers. The states should play an important and logical role in regulating small investment advisers whose activities are likely to be

[31] Title III, National Securities Markets Improvement Act, Public Law No. 104-290.

> concentrated in their home state. Larger advisers, with national businesses, should be registered with the Commission and be subject to national rules.[32]

The Coordination Act was designed to enhance investor protection while reducing unnecessary, overlapping, and inconsistent regulation. As the name of the law implies, Congress sought to create a new and improved regulatory model that *coordinates* regulation of investment advisory firms and their employees by allocating responsibility for larger firms to the SEC and allocating responsibility for smaller firms and individual financial planners to the states. This overriding legislative intent was well summarized in the Commission's proposed rules to implement the law:

> The reallocation of regulatory responsibilities grew out of Congress' concern that the Commission's resources are inadequate to supervise the activities of the growing number of investment advisers registered with the Commission, many of which are small, locally operated, financial planning firms. Congress concluded that if the overlapping regulatory responsibilities of the Commission and the states were divided by making the states primarily responsible for smaller advisory firms and the Commission primarily responsible for larger firms, the regulatory resources of the Commission and the states could be put to better, more efficient use.
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> Congress also was concerned with the cost imposed on investment advisers and their clients by overlapping, and in some cases, duplicative, regulation. In addition to the Commission, forty-six states regulate the activities of investment advisers under state investment adviser statutes. States generally have asserted jurisdiction over investment advisers that "transact business" in their states. Consequently, many large advisers operating nationally have been subject to the differing laws of many states. Compliance with differing state laws had imposed significant regulatory burdens on these large advisers. Congress intended to reduce these burdens by subjecting large advisers to a single regulatory program administered by the Commission.[33]

The Coordination Act prohibits an investment adviser from registering with the SEC unless it has more than $25 million in assets under management[34] or is an adviser to

[32] S.Rpt.104-293, pp. 3-4 (June 26, 1996).
[33] *SEC Proposed Rules Implementing Amendments to the Investment Advisers Act of 1940,* Release No. IA-1601, File No. S7-31-96 (December 20, 1996). Since enactment of the Coordination Act, the states of Colorado, Iowa, and Ohio have enacted investment adviser laws; thus, the State of Wyoming is the only state without an investment adviser statute.
[34] The $25 million threshold was intended to provide a bright line test for allocating regulatory responsibility of advisers between the Commission and the states, representing a rough cut between advisers that generally do business in interstate commerce and those that generally have more localized practices. We note that the report accompanying the Senate-passed bill notes that the Commission "may also use its exemptive authority under the bill to raise the $25 million threshold higher as it deems appropriate in keeping with the purposes of the Investment Advisers Act" and concurred in a recommendation of NASAA to review the appropriateness of this threshold *at least every three years*. S.Rpt. 104-293, p. 5 (June 26, 1996). To our knowledge, the Commission has not yet conducted such a review.

a registered investment company or fits within another exemption. To effectuate the Act's central purpose of reducing regulatory redundancy, section 203A(b)(1) of the Advisers Act provides that "[n]o law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or a supervised person of an investment adviser shall apply . . ." to any federally registered adviser or supervised person thereof. This preemption of state authority over federally registered advisers is the key component in the allocation of regulatory responsibility between the SEC and the states.

The Coordination Act carves out only four narrow exceptions for state authority over federally registered advisers and their employees:

1. *Enforcement actions for fraud and deceit.* The Act preserves state authority to investigate and bring enforcement actions "with respect to fraud or deceit against an investment adviser or person associated with an investment adviser."[35]
2. *Notice filings.* The Act preserves state authority to require "the filing of any documents filed with the Commission pursuant to the securities laws solely for notice purposes, together with a consent to service of process and any required fee."[36]
3. *Fees.* The Act preserves the ability of states to impose and collect "filing, registration, or licensing fees . . ."[37]
4. *Investment adviser representatives who have a place of business in the state.* The Act allows states to "license, register, or otherwise qualify an investment adviser representative who has a place of business in the state."[38]

The ICAA strongly supported enactment of the Coordination Act. The patchwork of inconsistent and varying state provisions that existed prior to the Coordination Act created unnecessary regulatory costs, burdens, and inefficiencies without enhancing investor protection. The Coordination Act's allocation of regulatory responsibility between the SEC and the states enhances investor protection, provides for more efficient use of limited regulatory resources, and reduces burdensome and unnecessary regulatory costs.

Coordination Act Scorecard: Eliminating Duplicative State Regulation

The Coordination Act represents a grand experiment in new federalism. By and large, we believe the results have been successful in achieving the objectives of the legislation.

[35] Section 203A(b)(2), Investment Advisers Act of 1940.
[36] Section 307(a), Investment Advisers Supervision Coordination Act.
[37] Section 307(b) and (c), Investment Advisers Supervision Coordination Act.
[38] Section 203A(b)(1)(A), Investment Advisers Act of 1940. This provision was added during the final hours of debate on the legislation and represented a compromise between the Senate-passed bill (which did *not* contain such a provision) and state regulators, many of whom generally opposed preemption of state laws. The ICAA strongly supported the Senate-passed bill and we continue to believe that a "cleaner and deeper" demarcation between federal and state authority would be preferable.

The law's stated goal of eliminating duplicative regulation of larger advisers by the states has, with a few notable exceptions, worked well. Since passage of the Coordination Act, we have communicated regularly with NASAA and various states in an effort to achieve uniform implementation of the law and accompanying regulations. As early as November 20, 1997, we reported to NASAA that "a majority of states appear to be complying with both the spirit and the letter of the Coordination Act," while noting that the actions of a minority of states "may threaten these positive efforts."[39] Our primary concerns have focused on laws or regulations in a few states that run counter to the provisions and purposes of the Coordination Act, including those that: (1) fail to recognize the national *de minimis* provision that exempts from state regulation advisers with five or fewer clients in a state; (2) require the filing of documents and/or payment of fees by investment adviser representatives who do not have a place of business in the state, (3) impose an additional layer of regulation on federally registered investment advisers and their supervised persons;[40] (4) require the filing of documents and other materials that are not required to be filed with the SEC, and (5) otherwise interfere with uniformity.

We sincerely appreciate the continuing efforts of NASAA and the vast majority of states to achieve uniform implementation of the Coordination Act. Nonetheless, it is extremely regrettable that a few states continue to thwart this goal.[41] *Unless and until all states have implemented laws and regulations that are consistent with the spirit and letter of the Coordination Act, one of the major purposes of the law will not be fully realized*.

We have taken steps to address this problem through legislation.[42] We also urge the Commission to assume a more active role in urging recalcitrant states to comply with the mandates of federal law. We believe state regulators and legislators will be open to receiving information from the Commission regarding the purposes and provisions of the Coordination Act. We hope the Commission will take steps to communicate more

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[39] Letter from ICAA Executive Director David G. Tittsworth to NASAA Executive Director Neal E. Sullivan (November 20, 1997).

[40] The SEC's release proposing rules to implement the Coordination Act, *supra, fn. 16,* stated: "States may not, however, indirectly regulate activities of Commission-registered advisers by enforcing state requirements that define 'dishonest' or 'unethical' business practices unless the prohibited practices would be fraudulent absent the requirements." In providing technical assistance to Senate personnel drafting the Coordination Act, the SEC staff stated that the provision "limiting the [states'] authority to bringing enforcement actions [for fraud and deceit] *precludes a state securities commission from re-regulating advisers by issuing anti-fraud rules.*" Memorandum from the Division of Investment Management to the Senate Securities Committee Staff, File Docket No. F7-98 (May 16, 1996) (emphasis added).

[41] For example, the Texas State Securities Board recently transmitted legislative proposals to the Texas legislature that, if enacted, would run afoul of the Coordination Act in various ways, *e.g.*, by authorizing the registration and payment of fees by investment advisers who do not have a place of business in the state, by authorizing notice filings and payment of fees from SEC-registered advisers with five or fewer clients in the states, and by treating investment advisers and dealers synonymously. *See* Letter from David G. Tittsworth, Executive Director, Investment Counsel Association of America, Inc. to Denise Voigt Crawford, Securities Commissioner, State Securities Board (April 20, 2000).

[42] In an attempt to achieve greater uniformity, the ICAA, in close consultation with NASAA and others, has submitted legislative recommendations to the Congress that would clarify various provisions of the Coordination Act. *See ICAA Legislative Amendments re: Proposed Securities Markets Improvement Act* (March 24, 1999) (available on the ICAA's web site under "Comments and Statements).

actively with states that have implemented or are considering laws and regulations that are inconsistent with the Coordination Act.

Coordination Act Scorecard: The Revolution in SEC Adviser Regulation

On the other hand, the record is crystal clear that the SEC's regulatory, inspection, and enforcement activities with respect to investment advisers have increased dramatically since implementation of the Coordination Act. *Collectively, these efforts represent a revolution in the treatment of investment advisers by the SEC:*

- When the Coordination Act was enacted in 1996, there were approximately 22,500 advisers registered with the SEC. Today, there are approximately 8,000 advisers registered with the SEC.[43] Obviously, this means that the SEC can concentrate its resources on a much smaller universe of advisers.

- At the same time, the SEC has devoted increased regulatory resources to the investment adviser area. In 1997, the SEC created the Task Force on Investment Adviser Regulation. During its short existence, the task force already has completed a number of rules adopted or proposed by the Commission, including various regulations implementing the Coordination Act,[44] new rules governing performance fees,[45] rules requiring the filing of Year 2000 readiness reports by advisers,[46] proposed rules regarding so-called pay-to-play abuses,[47] a proposed rule regarding the broker-dealer exception under the Advisers Act,[48] proposed privacy rules,[49] and proposed rules overhauling Form ADV and establishing an electronic filing system for investment advisers.[50] Additional rules that are likely to be considered include exemptions from restrictions on principal trading under the Advisers Act,[51] as well as

[43] *See Electronic Filing by Investment Advisers; Proposed Amendments to form ADV,* Release No. IA-1862; 34-42620; File No. S7-10-00, at p. 5 (April 5, 2000).
[44] *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Release No. IA-1601, File No. S7-31-96 (May 22, 1997); *Exemption for Investment Advisers Operating in Multiple States; Revisions to Rules Implementing Amendments to the Investment Advisers Act of 1940; Investment Advisers with Principal Offices and Places of Business in Colorado or Iowa,* Release No. IA-1733, File No. S7-28-97 (July 17, 1998).
[45] *Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account,* Release No. IA-1731, File No. S7-29-97 (July 15, 1998).
[46] *Investment Adviser Year 2000 Reports,* Release No. IA-1769, File No. S7-20-98 (October 1, 1998).
[47] *Political Contributions by Certain Investment Advisers,* Release No. IA-1812, File No. S7-19-99 (August 4, 1999).
[48] *Certain Broker-Dealers Deemed Not To Be Investment Advisers,* Release Nos. 34-42099; IA-1845; File No. S7-25-99 (November 4, 1999).
[49] *Privacy of Consumer Financial Information (Regulation S-P),* Release Nos. 34-42484, IC-24326, IA-1856; File No. S7-6-00 (March 2, 2000).
[50] *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV,* Release No. IA-1862; 34-42620; File No. S7-10-00 (April 5, 2000).
[51] *Remarks of SEC Chairman Arthur Levitt Before the Security Industry Association's Legal and Compliance Seminar* (April 5, 1999): ". . . I believe this is the right time to consider whether it might be appropriate to provide an exemption from the [Adviser Act's] restrictions on principal trading."

rules relating to advertising and performance reporting, books and records, and custody.[52]

- During the same time, the SEC's inspection activities of investment advisers have increased dramatically, directly addressing one of the major concerns underlying passage of the Coordination Act. In 1996, when the Coordination Act was being debated, the SEC estimated that the average cycle for routine adviser inspections was once every 15-30 years. Today, the SEC's regional offices have implemented plans to inspect every registered investment adviser at least once every 4-5 years and to inspect new advisers within their first year of business. Since enactment of the Coordination Act, the SEC also has stepped up its targeted inspections or "sweeps" of advisers on particular issues of concern, including the 1997 soft dollar sweep of 280 investment advisers, a follow-up sweep on best execution practices, sweep of advisers on performance issues, and visits in 1998 to nearly 60% of advisers nationwide regarding Year 2000 readiness. Earlier this month, the Director of the SEC's Office of Compliance Inspections and Examinations sent a letter to all registered investment advisers outlining 12 areas of common violations found during compliance examinations of investment advisers.[53]

- Statistics indicate that in recent years the SEC has brought more enforcement cases involving violations of the Investment Advisers Act of 1940, the penalties imposed in these actions have been harsher, and more cases have been litigated.[54]

In conclusion, the record is indisputable that the SEC has exceeded expectations in beefing up its programs governing the investment adviser industry since enactment of the Coordination Act. Today, investment advisers are subject to an increasingly complex regulatory environment and are subject to rigorous oversight by the Commission.

Definition of Investment Adviser

The unprecedented changes occurring in the financial services industry have, in some cases, resulted in the blurring of lines that traditionally have defined the respective roles, services, and characteristics of investment advisers, broker-dealers, banks, financial planners, and other entities who provide some type of "advice." This, in turn, presents fundamental questions about the scope of coverage of the Advisers Act. What is an investment adviser? Under what circumstances should an entity that provides investment advice be excluded from the definition of "investment adviser" and, by extension, the legal and regulatory requirements governing investment advisers? *Considering that more*

[52] *Supra*, fn. 3., at pp. 9-10.

[53] Letter from Lori A. Richards to all SEC-registered investment advisers (May 1, 2000). Following are the 12 areas cited by Ms. Richards: (1) duty to disclose; (2) trade allocations; (3) advertising representations to clients; (4) performance claims; (5) personal trading; (6) advisory agreements; (7) books and records; (8) referral arrangements; (9) use of brokerage; (10) custody or possession of client assets; (11) recidivism; and (12) inadequate internal control and supervisory procedures.

[54] *See "SEC Enforcement Trends 'Ominous' for Investment Advisers," IA Week* (February 7, 2000), citing Richard Marshall (Kirkpatrick & Lockhart): "Investment advisers are more likely to be the subject of an enforcement action and, when such actions are brought, the penalties are likely to be harsher."

and more non-traditional entities are migrating toward various types of advisory services, we believe that issues involving the scope of the Advisers Act are the most important issues facing policy makers, the Commission, and the investment advisory profession.

In considering the various exceptions to the definition of investment adviser set forth in the Advisers Act, it seems reasonable to assess whether there is in fact a legitimate basis for each exception. In doing so, the fundamental question should be whether an entity is providing investment supervisory services. *A consistent, functional test should be employed*. From an investor's perspective, if it looks like an investment adviser and acts like an investment adviser, then it should be subject to the same duties and obligations as an investment adviser.

The Broker-Dealer Exception

Section 202(a)(11) of the Advisers Act defines "investment adviser" as "any person who, for compensation, engages in the business of advising others, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." The law also sets forth several exceptions to the definition of investment adviser, including "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[55]

Last year, the Commission issued a proposed rule that addresses the application of the Advisers Act to broker-dealers who offer their customers full service brokerage, including advice, for an asset-based fee instead of or in addition to traditional commissions, mark-ups, and mark-downs.[56] The ICAA believes the proposed rule involves extremely important issues that require careful and serious deliberation.

We certainly believe a rule is needed. It is clearly evident that broker-dealers are migrating toward asset-based fees. One of the reasons for this trend is increased competition in execution services, primarily from the proliferation of electronic communications networks (ECNs) and other Internet-based entities that offer execution services at a fraction of traditional full service brokerage costs. As commissions are being squeezed – and as the number of investors and assets continues to grow – many full service brokers have begun to diversify their products and services by offering on-line trading, asset-based fees, various advisory programs, and other additions to their traditional programs in an effort to respond to competitive forces and to capitalize on the major influx of assets from a new generation of investors.

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[55] Section 202(a)(11)(B), Investment Advisers Act of 1940.

[56] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 34-42099; IA-1845 (November 4, 1999).

As noted in the proposed rule, these new brokerage programs involve the receipt by broker-dealers of "special compensation."[57] Up until the proposed rule was released, receipt of special compensation has meant that a broker-dealer could not claim the exception in the Advisers Act. The fact that fee-based brokerage programs have proliferated contrary to specific provisions of the Advisers Act is clearly an undesirable regulatory result. There is an obvious need for the Commission to provide explicit guidance to broker-dealers, investment advisers and, most importantly, to investors, as to where the distinguishing lines between brokerage and advisory services will be drawn and how they will be enforced in the future.

The need for explicit guidance is even more compelling when considering the growth of high profile marketing touting the virtues of broker-sponsored fee-based programs and advisory services. During the past several months alone, full service brokers have spent millions of dollars on advertising campaigns designed to attract consumers to their new programs, including commercials that emphasize advisory services and the merits of asset-based compensation.[58] Given the prominence of these efforts, it is incumbent upon the Commission to take prompt and decisive action that will benefit investors by helping them understand the types of services that are available and the differences between brokerage and advisory services.

Despite dramatic changes occurring in financial services, we believe that fundamental differences still exist between most advisers and most broker-dealers. Broker-dealers execute trades while advisers do not. Broker-dealers typically have custody of client assets while most advisers do not. Broker-dealers generally do not exercise discretionary authority over client accounts, while most SEC-registered investment advisers do. Broker-dealers traditionally have employed sales forces compensated primarily by commissions while most advisers have not. In street parlance, brokers are the "sell" side while advisers are the "buy" side. *Anyone who knows the industry understands that there is a wide cultural gap separating most advisers and most brokers.*

It is understandable that many full service brokers are anxious for the Commission to adopt the proposed rule in order to ensure that their fee-based accounts are not "re-designated" as advisory accounts.[59] Stated differently, the brokerage community would not have urged the Commission to issue the proposed rule were it not for the fact that there are substantial differences in the manner in which investment advisers and broker-dealers are regulated.[60]

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[57] *Id.*, p. 7: "Fee-based compensation may constitute special compensation under the Act because it involves the receipt by a broker of compensation other than traditional brokerage commissions."

[58] Contrary to assertions and implications in certain broker-dealer advertisements, fee-based compensation is not a "new" development. The ICAA has specifically endorsed fee-only compensation since 1937.

[59] Ironically, the broker-dealer industry's efforts to evade regulation under the Advisers Act stands in stark contrast to NASDR's claims that advisers are subject to "less regulation."

[60] In contrast, when an investment adviser decides to engage in the brokerage business, it is required to comply fully with the Securities Exchange Act of 1934 and NASD rules. Advisers have not requested an exemption from these requirements.

There are at least four aspects of the Advisers Act and accompanying laws governing the conduct of investment advisers that are significantly different from those applicable to broker-dealers. First, advisers owe a strict fiduciary duty to each of their clients that extends well beyond any similar legal obligation of broker-dealers. Second, section 206(3) of the Advisers Act prohibits an investment adviser from selling or purchasing any security to or from a client when acting as a principal for its own account, unless each such transaction is disclosed in writing to the client and the client consents to it.[61] Broker-dealers typically have an existing inventory of securities and thus have a natural incentive to buy and sell such securities to and from clients on a principal basis. Third, as outlined above, the Advisers Act requires investment advisers to make full and fair disclosures that differ substantially in timing and content from any disclosures required of broker-dealers. Finally, the Advisers Act flatly prohibits testimonials and past specific recommendations in advertising. Brokers frequently employ testimonials in advertising and such use appears to be increasing.

Our comment letter details various concerns we have with the proposed rule.[62] While we agree with the Commission that a functional test that focuses on the nature of services provided – rather than the form of the broker-dealer's compensation – is appropriate in determining whether a brokerage account falls within the Advisers Act, we believe the Commission's functional analysis does not go far enough. We believe that, at a minimum, the test proposed by the Commission should be modified as follows:

- The rule should treat discretionary brokerage accounts that charge commissions in the same manner that it treats discretionary brokerage accounts that are fee-based.

- The rule should clarify that an account that receives discretionary advisory services is by definition not "solely incidental" to a broker-dealer's business. The Commission should provide the industry and the public with better guidance as to the definition of "solely incidental."

- The rule should prohibit broker-dealers from advertising advisory services that are "solely incidental" to the conduct of the broker's primary business.

There is broad agreement on these points from a wide cross-section of interests, including consumer groups,[63] state regulators,[64] financial planners,[65] and others. We trust the Commission will carefully consider these views as it seeks to assess the long-term

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[61] Many observers believe that the disclosure and consent requirements of section 206(3) operate as a *de facto* prohibition on so-called principal transactions by investment advisers.
[62] *See* Letter from ICAA Executive Director David G. Tittsworth to Jonathan G. Katz, Secretary, Securities and Exchange Commission (January 12, 2000). The comment letter is available on the SEC's web site and the ICAA's web site (under "Comments and Statements").
[63] *See* Comment letter from Barbara L.N. Roper, Consumer Federation of America (January 14, 2000).
[64] *See* Comment letter from Bradley W. Skolnik, North American Securities Administrators Association (January 14, 2000).
[65] *See* Comment letter of Duane R. Thompson, Financial Planning Association (January 14, 2000); comment letter of Robert P. Goss, Certified Financial Planner Board of Standards (January 13, 2000);

ramifications of this and other rules that deal with the distinctions between advisers and broker-dealers.

It is true that the broker-dealer exception was enacted in 1940 and that dramatic changes have occurred during the last 60 years. Obviously, until Congress chooses to amend it, the Commission is bound to uphold the Advisers Act. More fundamentally, however, we urge the Commission to step back and ask itself a few basic questions that we believe can and should help guide consideration of these important issues. The first is whether there is – or should be – a distinction between advisers and brokers. If one were writing on a clean slate today, would it be appropriate to make a distinction between entities that effect securities transactions and those who provide investment supervisory services? We believe the clear answer is "yes." The next basic question is what type of legal and regulatory framework should govern investment advisers. We believe the essential structure of the Advisers Act, and regulations and decisions thereunder, is both appropriate and effective in terms of protecting investors from potential abuses and conflicts of interests. While one can argue about the details, no one can seriously dispute that the basic protections afforded by the Advisers Act serve investors and the advisory profession well. If the Commission agrees there are fundamental distinctions between advisers and broker-dealers, we believe the outcome of the pending rule will fall into place.[66] Issuing a rule that blurs these distinctions will only serve to confuse and confound investors.

Finally, we believe the Commission should be mindful of the *cumulative* effect of the broker-dealer exception rule *and* the anticipated rule on principal transactions under the Advisers Act. As noted above, one of the primary differences between broker-dealers and investment advisers is the restriction on principal trading that applies to investment advisers.[67] No comparable provision exists in the Exchange Act or other laws or regulations governing broker-dealers. Congress included section 206(3) in the original Advisers Act due to its concerns about potential overreaching by advisers at the expense of their clients. As such, section 206(3) represents one of the major differences between advisers and broker-dealers and the laws and regulations governing each.

The broker-dealer industry clearly supports efforts to revise the current principal trading prohibition in the Advisers Act. For example, the broker-dealer industry proposed legislative changes to Congress last year that, among other things, would amend section 206(3) of the Advisers Act to allow principal trades and agency cross transactions

[66] Consistent with functional regulation, the Advisers Act should govern investment supervisory activities provided by any entity; brokerage activities by any entity should be governed by the Securities Exchange Act of 1934 and NASDR rules.

[67] Section 206(3) of the Advisers Act provides that: "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transactions."

by an investment adviser under much broader circumstances than the law currently allows.

We believe the Commission should exercise extreme caution in considering changes to the principal trading restrictions under section 206(3) of the Advisers Act. We certainly are aware that Chairman Levitt indicated last year that "this is the right time to consider whether it might be appropriate to provide an exemption from the restrictions on principal trading."[68] The ICAA obviously cannot anticipate what may be proposed in this area and we will review any such rulemaking carefully, if and when it is issued. However, the possibility of the SEC granting a new exemption under section 206(3), particularly when combined with the proposed rule that gives broker-dealers increased latitude to avoid the protections of the Advisers Act, raises concerns of a "slippery slope" whereby the statutory distinctions between brokerage activities and advisory services are eroded – or even eliminated – by a series of rulings or actions by the Commission.

The ICAA commends the Commission for considering these important issues. The trend toward asset-based fees for advisory services by broker-dealers clearly conflicts with existing statutory provisions and interpretations thereof and this conflict needs to be addressed and resolved. While we applaud those in the brokerage industry who now have decided to employ a fee-based approach (an approach that has been in use by investment counsel firms for several decades), we believe the interests of investors and of the regulated community will best be served by a *functional* test that focuses on the nature of services provided and/or marketed, while recognizing and preserving the fundamental differences between brokerage activities and advisory services.

The Bank Exception

Banks also enjoy an exception under the Advisers Act.[69] Without belaboring the point, the ICAA has consistently opposed this exemption. The reason was summarized in a 1972 letter to the Commission filed by the ICAA opposing a request by Chase Investors Management Corporation (CIMC) for an order declaring it to be a person not within the definition of investment adviser under Section 202(a) of the Advisers Act:[70]

> The thrust of the . . . memorandum in support of the application is that CIMC would be subject to regulation under the National Banking Act and the Bank Holding Company Act, by the Comptroller of the Currency and by the Federal Reserve Board. However, the main interest of those federal authorities is in preventing an affiliate of a bank from engaging in unsound, fraudulent or other practices which would be inimical to the soundness and reputation of the bank and harmful to the depositors of the bank and, with respect to bank holding companies, that their activities should be conducted in a manner consistent with the public interest. *These provisions, while laudatory in scope and purpose, fail*

[68] *Remarks Before the Securities Industry Association's Legal and Compliance Seminar* (April 13, 1999).
[69] Section 202(a)(11)(A), Investment Advisers Act of 1940.
[70] Investment Advisers Act Release No. 333; Administrative Proceeding File No. 3-3859 (August 21, 1972) (emphasis added).

to provide the specific investor protection afforded by the [Advisers] Act and SEC regulation thereunder. The fact that certain types of investment advisory services might possibly be offered by the bank, or a subsidiary of the bank, or a holding company itself free of SEC regulation under the [Advisers] Act is not a satisfactory reason for granting the exemption requested by CIMC. A firm which is organized and operates in the same manner as other registered investment advisory firms should be required to observe the same rules.[71]

We believe the bank exception in the Advisers Act has more to do with jurisdictional wrangling – between various federal regulatory banking and securities regulators as well as various Congressional committees – than sound public policy. If policy makers are truly concerned about appropriate and *functional* regulation of various entities in the financial services industry, it is clear that the banking exception in the Advisers Act should be amended to provide that banks that act as investment advisers will be subject to the same laws and regulations governing other investment advisers. This concept was clearly and consistently articulated by Chairman Levitt during debate on financial services modernization legislation:

> The statutes that form the foundation for both banking and securities regulation remain based on the 60-year old assumption that the Glass-Steagall Act prohibits banks from engaging in most securities activities. Although that assumption is outmoded, the laws continue to exempt banks from the requirements applicable to brokers, dealers, and investment advisers even though banks conduct these activities. This means that a bank's securities activities are subject to the bank regulatory scheme with its primary focus on the safety and soundness of the <u>bank</u>, rather than the securities regulatory scheme, focused on disclosure, investor protection, and the maintenance of fair and orderly markets.
>
> As the Commission has urged for more than a decade, *a system of functional regulation would eliminate the inconsistencies between regulation of securities activities of banks and securities activities of Commission-regulated entities, providing enhanced investor protection.*
>
> . . .
>
> *To assure adequate investor protection, the Commission believes that bank securities activities must be brought within the securities regulatory framework. Such an approach would ensure that the securities activities of all market participants – regardless of the structure in which they are conducted – would be subject to a single set of standards, consistently applied by one expert regulator*.[72]

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[71] Letter from Ramsay D. Potts, ICAA Counsel, to Ronald F. Hunt, Secretary, Securities and Exchange Commission (October 6, 1972) (emphasis added).

[72] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization, Before the Committee on Banking and Financial Services (May 22, 1997) (emphasis added).

As part of the Gramm-Leach-Bliley Act[73] that was enacted last year after years of debate, Congress amended section 202(a)(11)(A) of the Advisers Act to provide that the term "investment adviser" will include a bank or bank holding company that "serves or acts as an investment adviser to a registered investment company. . ."[74] While the ICAA believes this provision is a step forward in attaining appropriate functional regulation, it certainly begs the question of why banks that act as an investment adviser in other cases should not also be subject to the protections and regulations of the Advisers Act.

The Accountant Exception

The Advisers Act also contains an exception from the definition of "investment adviser" for "any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession"[75] In determining whether this exception is available depends upon the facts and circumstances of each case. The SEC staff has identified three major factors to be considered: (1) most importantly, whether the professional holds himself out publicly as an investment adviser or financial planner (by means such as general advertising, mailings, letterheads or business cards, telephone listings, etc.); (2) whether the investment advice given is in connection with and reasonably related to the professional services rendered; and (3) whether the professional's fee structure for investment advisory services is different from the schedule for the professional services.[76] The SEC staff also has permitted accounting firms, subject to specified conditions, to establish and register only an affiliated entity under the Advisers Act (rather than the accounting firm itself) to supervise the rendering of general investment consulting and tax planning services by partners or other professionals of the accounting firm.[77]

As with other segments of the financial services industry, an increasing number of accountants appear to be migrating toward the investment advisory profession.[78] While accountants traditionally gave investment advice to clients only when asked and only on an informal basis, more accountants are now approaching their clients about their investments and providing various investment tools.

Consistent with the views expressed above, we believe the Commission should employ a functional test in determining whether accountants – and other professionals – should be regulated under the Advisers Act. An accountant should be subject to provisions of the Advisers Act if the advisory services rendered are more than solely

[73] Public Law No. 106-102.
[74] Section 217, Gramm-Leach-Bliley Act. Section 217 also provides that, in the case of a bank, if the advisory services are provided through a "separately identifiable department or division," such department or division, and not the bank itself, shall be deemed to be the investment adviser.
[75] Section 202(a)(11)(B), Investment Advisers Act of 1940.
[76] Lemke & Lins, *Regulation of Investment Advisers*, at 1-11, 1-12 (1999).
[77] *Id*, at 1-12.
[78] *See, e.g., "CPAs & advice: Should they? Can they?"*, *Investment News* (November 29, 1999). "Before the recent liberalization of rules governing their practice, accountants colored strictly within the lines. Today, the lines are much less definite. Because many clients can do their taxes online or with relatively inexpensive software, more and more accountants are looking to break into investment advice."

incidental, if the accountant holds itself out to be an investment adviser, if the advisory services are not reasonably related to or are not provided in connection with accounting services, or if the accountant employs a separate compensation scheme in connection with the advisory services it provides.

The Publishers Exception

The Advisers Act also contains an exception from the definition of "investment adviser" for "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation."[79] Particularly due to the proliferation of Internet-based activities that relate to investment advice, we believe this exception presents several important and challenging issues for the Commission and policy makers.

The leading case interpreting the publishers exception is *Lowe v. Securities and Exchange Commission.*[80] In *Lowe*, the U.S. Supreme Court traced the history of the Advisers Act, noting that:

> The legislative history plainly demonstrates that Congress was primarily interested in regulating the business of rendering personalized investment advice, including publishing activities that are a normal incident thereto. On the other hand, Congress, plainly sensitive to First Amendment concerns, wanted to make clear that it did not seek to regulate the press through the licensing of nonpersonalized publishing activities.[81]

In concluding that Lowe was an investment adviser and not entitled to the publishers exception, the Court focused on the meaning of the words "bona fide"[82] and "general and regular circulation"[83] in the statute. But we believe the most important aspect of the decision that deserves a serious review is the Court's reliance on its finding that the scope of the Advisers Act revolves around the concept of "personalized" advice:

> The [Advisers] Act was designed to apply to those persons engaged in the investment advisory profession – those that provide personalized advice attuned

[79] Section 202(a)(11)(D), Investment Advisers Act of 1940.
[80] 472 U.S. 181 (1985).
[81] *Id*., at 204.
[82] "The only modifier that might arguably disqualify the newsletters are the words 'bona fide.' Notably, however, those words describe the publication rather than the character of the publisher; hence Lowe's unsavory history does not prevent his newsletters from being 'bona fide.' In light of the legislative history, this phrase translates best to 'genuine': petitioners' publications meet this definition: they are published by those engaged solely in the publishing business and are not personal communications masquerading in the clothing of newspapers, news magazines, or financial publications. Moreover, there is no suggestion that they contained any false or misleading information, or that they were designed to tout any security in which petitioners had an interest." *Id*, at 208-209.
[83] "Further, petitioners' publications are 'of general and regular circulation.' Although the publications have not been 'regular' in the sense of consistent circulation, the publications have been 'regular' in the sense important to the securities market: there is no indication that they have been timed to specific market activity, or to events affecting or having the ability to affect the securities industry." *Id*., at 209.

> to the client's concerns, whether by written or verbal communication. The mere fact that a publication contains advice and comment about specific securities does not give it the personalized character that identifies a professional investment adviser. Thus, petitioners' publications do not fit within the central purpose of the Act because they do not offer individualized advice attuned to any specific portfolio or to any client's particular needs. On the contrary, they circulate for sale to the public at large in a free, open market – a public forum in which typically anyone may express his views.[84]

The pending case brought by the Commission against "Tokyo Joe"[85] illustrates the conundrum of whether the holding in *Lowe* is appropriate in today's environment. According to the Commission's memorandum in opposition to the defendant's motion to dismiss:

> Since July 1998, the Defendants have operated a website on the Internet called "Tokyo Joe's." That site is a source of securities market information and investment advice concerning individual stocks and day trading techniques. Portions of the website are accessible to the public for free, including sections that purport to display Park's past trading performance and sections that purport to be testimonials from satisfied subscribers to the website's "members only" sections. For a monthly fee, ranging up to $200 per month, members of the public are invited to join S.A. and gain access to these "members only" sections of the website. In these sections, paying members receive Park's investment advice and stock picks before they are posted to the public portions of the website. In addition, these paying clients receive Park's e-mails containing additional investment advice and stock picks throughout the day – again, ahead of the general public. Finally, members have access to a "chatroom" on the website in which Park dispenses real time investment advice in a dialogue with his clients.

Citing *Lowe*, defendants have argued that they cannot be deemed investment advisers within the meaning of the Advisers Act "because they do not offer personalized advice" and that Park's "expression of ideas and opinions articulated over the Internet is not investment advice." They also argue that defendants do not owe a fiduciary duty to their subscribers and "are not otherwise in a relationship of 'trust and confidence' with them."[86]

While the district court this month refused to grant the defendant's motion to dismiss, the case represents a few of the important issues facing the Commission and the advisory profession. The advent of cyberspace has ushered in a new era where an increasing number of entities are offering a wide variety of "advisory" services for compensation. While we are mindful of important First Amendment considerations, we also believe that, at some point, these types of services may cross the line of free speech

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[84] *Id.*, at 207-208.
[85] *SEC v. Yun Soo Oh Park,a/k/a Tokyo Joe, and Tokyo Joe's Societe Anonyme Corp.*, Case No. 00 C 0049 (U.S. Dist. Court for the No. District of Illinois).
[86] *Id.*, Memorandum of Law In Support of Motion to Dismiss.

and enter investment adviser territory. In particular, we strongly believe that the holding in *Lowe* – and its reliance on *personalized* advisory services – needs to be reexamined in light of these significant developments.

As demonstrated by the *Tokyo Joe* case, the Commission obviously is aware of the fact that investors have new options in how they receive information and, in some cases, advice regarding securities. We believe there is an explosion in the provision of "advisory" services via the Internet. Because of the rapidly increasing availability of electronic platforms and the enormous capacity to communicate with millions of investors via such services, we urge the Commission to continue its efforts to ensure that entities that provide investment advice for compensation are appropriately regulated. As we have emphasized above, a *functional* test should be employed: if an entity is in the business of providing investment advice regarding securities for compensation – whether such advice is rendered in person or via a website – the entity should be subject to the provisions of the Advisers Act that have served investors well for 60 years.

Conclusions

In closing, we wish to commend Paul Roye for the central role he has played in convening today's roundtable. Without his leadership, we know that this important undertaking would not have been possible. We are certainly mindful of other important issues facing Mr. Roye and the staff of the Division of Investment Management and greatly appreciate their willingness to add this roundtable to their daunting list of tasks.

The ICAA stands ready to assist the Commission as it seeks to address the many important issues raised today. We look forward to continuing our dialogue with you on these and other matters affecting the investment advisory profession and truly appreciate the opportunity to participate in today's historic discussion.

May 23, 2000

June 13, 2000

BY HAND AND ELECTRONIC FILING

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Release Nos. IA-1862, 34-42620; File No. S7-10-00; Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to provide these comments regarding the Commission's proposed rules related to electronic filing by investment advisers and revisions to Form ADV.[2]

Introduction and Summary

On April 5, 2000, the Commission announced the development of an electronic filing system for investment advisers, the Investment Adviser Registration Depository (IARD). The Commission also proposed substantial amendments to Form ADV, designed to modernize the registration process and enhance information that investment advisers provide to their existing and prospective clients. As part of this enhanced disclosure, a firm would be required to provide clients with a narrative brochure in plain English describing its practices, policies, and procedures, along with brochure supplements providing additional information regarding specific employees of the firm.

The ICAA applauds the Commission for establishing the IARD. This electronic filing system will permit federally registered advisers to make "one-stop" filings with

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[1] The ICAA is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 250 investment advisory firms that collectively manage in excess of $2 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[2] *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV,* Release Nos. IA-1862, 34-42620, April 5, 2000 ("Release").

both the Commission and with states in which they are required to notice file.[3] It will provide the Commission with a powerful tool to monitor advisers and gather useful data about the profession. Most important, the database will provide clients around the world with easy access through the Internet to significant information about investment advisers, including disciplinary history.

The ICAA also supports the Commission's goal of making advisory firm brochures more useful to clients. Form ADV has not been substantially amended since 1985 and is in need of modernization. We support the new requirement of a narrative brochure written in plain English as a logical and meaningful step toward improving disclosure for clients.

While agreeing with the Commission's investor protection goals, the ICAA has a number of comments regarding electronic filing and the new structure and substance of Form ADV. Following is a summary of our principal concerns:

- *Proposed Form ADV is too extensive.* Preparing proposed Form ADV, as a whole, will amount to a costly and burdensome task for investment advisers. The information required in Part 1 and Part 2 has been significantly expanded both in detail and in scope. In particular, we are concerned that:

    - The disclosure and delivery requirements appear to be most relevant to advisory firms and financial planners serving individual retail clients. Many of the proposed changes will have limited or no relevance to institutional clients, while imposing burdens on institutional advisers.
    - The proposed brochure will be too lengthy and dense for retail clients to read or understand (somewhat similar to a prospectus). Accordingly we have proposed a more streamlined version of the brochure.
    - The proposed form is unwieldy. An SEC-registered adviser will have to collect and manage information and drafting for Part 1A, Schedule A, Schedule B, Schedule D, Part 2A, Part 2B for many employees, the execution page, and various delivery requirements.

- *The proposed delivery requirements are too cumbersome.* The Commission proposes to require advisers to (a) continuously deliver "stickers" to clients when Form ADV is amended, (b) create summaries of material changes and track which summaries were delivered to which clients on particular dates, and (c) make an annual offer of a "clean" brochure. These requirements may be confusing to investors and will involve a substantial administrative effort by advisers. Below, we propose a simplified delivery regime.

- *The proposed brochure supplement is not feasible.* The brochure supplement (Part 2B) presents similar issues and problems. Although the Commission anticipates a one-page disclosure for each relevant employee, it may not

[3] This anticipated benefit of the system would be achieved only if all states accept notice filings electronically.

realize the operational difficulties of such an approach for firms with more than a few employees. Drafting, delivering, and constantly amending the supplements will be extremely costly and burdensome for firms with a significant number of employees and clients. Below, we propose two workable alternatives to the supplement concept.

- *The Commission appears to be requiring new legal duties.* The proposed brochure requirements to discuss policies, practices, and procedures related to a wide range of topics appear to create legal duties that have not been previously articulated.

- *The Commission should not use broker-dealer regulation as a model for investment adviser requirements.* The SEC appears to have taken Form BD and its related definitions as the model for Form ADV. This approach is inappropriate in certain circumstances.

We discuss below: (1) electronic filing through the IARD; (2) the Release and Form ADV generally; (3) Part 1A generally; (4) the proposed delivery requirements for Part 2; (5) Part 2A generally; and (6) Part 2B generally. For ease of reference, we have set forth our specific item-by-item comments with respect to Part 1A, Part 2A, and Part 2B in separate appendices that should be considered as part of this comment letter.

I. Electronic Filing through IARD

A. Transition timing

The Commission requests comment on the transition process and the timing of filing Form ADV and delivering the brochure to clients.[4] Gathering the information for Part 1 alone will involve significant time and effort. We believe advisers will need at least 60 days to complete Part 1. In addition, if the Commission does not narrow the scope and extent of the brochure and brochure supplements, drafting such documents will be an enormous undertaking. Advisers will need at least 180 days to gather the necessary information and create these documents and an additional 60 days to deliver new brochures and supplements to all clients.

In addition, we understand that filings with the states through IARD for investment adviser representatives may overlap with the schedule for filing Part 1A and/or Part 2A. We hope the Commission and the states will work together in the transition schedule to avoid overlapping or impractical requirements.

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[4] *E.g.*, Release at 22.

B. Paper filing of the brochure with the states

The SEC proposes to "roll out" Part 1 of Form ADV on the new IARD approximately one year before Part 2A is filed electronically.[5] In the interim, the Commission will not require SEC-registered advisers to file Part 2A with the Commission, but simply to provide Part 2A to their clients.[6] Because the Commission will not require the filing of Part 2A during this period, states would not be permitted to require Part 2A in notice filings by SEC-registered advisers.[7]

The SEC has proposed to "accommodate" the states' desire to receive Part 2A by "deeming" Part 2A to be filed with the Commission.[8] Thus, during the initial one-year roll-out period, advisers would be required to file Part 1 electronically with the SEC and the relevant states, while notice filing Part 2A on paper by mail with the various states that so require.

We strongly oppose this proposal. Requiring Part 2A on paper would be unnecessarily burdensome for firms already completely revising their Form ADVs and becoming familiar with the IARD. Further, Part 2A already must be provided to clients and prospective clients, so there is no investor protection rationale for the requirement. States will have all of the regulatory information they need in Part 1, including disciplinary history. We see no legitimate "notice filing" need for states to require advisers manually to file a copy of Part 2A, particularly where it is a stop-gap measure until the IARD is completed.[9]

C. Completeness check

The Commission notes that the system "will prevent an adviser from submitting an incomplete form or from entering inconsistent information at different places on the form."[10] We understand that broker-dealer firms have had problems with the CRD's completeness checks, especially with errors in the system that prevent timely filing by

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5 Release at 23.

6 The Commission does not intend to require advisers to file brochure supplements. Release at 68.

7 The Investment Adviser Supervision Coordination Act (Coordination Act) preempts states from regulating investment advisers registered with the SEC. Section 307(a) of the Act, however, provides: "Nothing in this title or any amendment made by this title prohibits the securities commission . . . of any state from requiring the filing of *any documents filed with the Commission* pursuant to the securities laws solely for notice purposes …." (emphasis added).

8 Release at 23 n.68.

9 The concept of notice filing is that SEC-registered firms should provide relevant states with *copies* of documents as *notice* of what they have filed with the SEC. Most states have been requiring investment advisers to file a copy of their registration document, Form ADV, and any amendments as notice. Some states require only page 1 of Form ADV as notice, along with a fee.

10 Release at 10-11.

firms. Apparently, the system sometimes rejects forms that are correctly completed because of assumptions made in the system that do not apply to all firms. It is important that the *Commission* control the completeness check function of IARD for Form ADV, *not* NASDR or the states, and that the system is flexible enough to be quickly adapted if errors are discovered in how the checks operate.

D. Commercial use

The Commission notes that IARD data will be available for commercial use.[11] We believe such commercial use of regulatory information is highly unusual in any profession, particularly given that personal information about certain advisory personnel is included. For example, we understand that CRD data is not similarly available. At a minimum, the Commission should ensure that private information, such as social security numbers and home addresses or telephone numbers, is not provided to commercial users.

II. General Comments on Form ADV

A. The IARD Should Be Tailored to Investment Advisers

NASDR is building the IARD for the Commission and the North American Securities Administrators Association (NASAA). We appreciate Chairman Levitt's statement that "NASDR will be operating in this venture as a contractor for [the SEC] and not as a self-regulatory organization for investment advisers."[12] We are nonetheless concerned that certain portions of the Release appear to focus more on attempting to conform Form ADV to Form BD and to accommodate dually registered entities than on establishing requirements that reflect characteristics of the advisory profession.

As we have stated consistently,[13] there are significant differences between the investment adviser profession and the broker-dealer industry. Nevertheless, the Commission appears to have used Form BD and its accompanying definitions as the model for Form ADV. For example, the Regulatory DRP (Disciplinary Reporting Page) contains questions completely unrelated to the investment advisory profession, referring to products, sales practices, and SRO-type sanctions. Similarly, the form includes questions about registered representatives and "minor rule violations."[14] This approach is not appropriate for advisers. To the extent questions relate to dual registrants, the

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11 Release at 12 n.26.

12 Opening Statement of Chairman Arthur Levitt, U.S. Securities and Exchange Commission, *Amendments to Form ADV* (April 5, 2000).

13 *E.g.*, Letter from ICAA Executive Director David G. Tittsworth to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Jan. 12, 2000); ICAA Report on Pay-to-Play and Investment Advisory Profession (May 15, 2000); Statement of David G. Tittsworth, Executive Director, ICAA, Roundtable on Investment Adviser Regulatory Issues, SEC (May 23, 2000).

14 *E.g.* Proposed ADV Part 1A, Item 5.B.2 and Item 11.E.2.

Commission should already have access to such information through broker-dealer filings.

We understand that the SEC hopes to achieve "synergies" in filing for dual registrants. But we believe that an accurate and appropriate form for advisers should not be sacrificed in the name of easing filing requirements for dual registrants. Historically, "true" dual registrants – that is, one entity registered as both an investment adviser and broker-dealer - are principally broker-dealers who decide to enter the investment advisory profession. Traditional investment advisers who register as broker-dealers do so, for the most part, to distribute proprietary mutual funds and create an *affiliate* or *subsidiary* to do so. We understand, however, that only "true" dual registrants will benefit from the synergies of linking the IARD with the CRD. Thus, aspects of this proposal that make Form ADV more consistent with Form BD primarily will benefit the broker-dealer industry, not traditional investment advisers.[15]

We are also concerned that the Release appears to indicate that NASDR has authority to set fees for various filings and to issue future releases.[16] Only the SEC and the states have such authority. The Release and proposed Form ADV are sprinkled with references to CRD numbers throughout, when there should be a separate *IARD* number for this *separate* system.

B. The Paper Version of Form ADV

We are disappointed that the Commission chose to release only the paper version of proposed Form ADV, which is not relevant to the vast majority of advisers. Few, if any, federally registered advisers will apply for hardship exemptions to use the paper form. It is clear that the on-line version of the form will not be identical to the paper version. For example, while the Release mentions electronic signatures, the proposed form does not. In addition, we understand that Schedule C will not exist on-line, but the Release does not make that clear. Similarly, Schedule D may not appear in the same manner on-line as it does in the proposal. The Commission should make clear which items, if any, may be amended directly on-line, without accessing various schedules.

Further, advisers need to see the instructions that will be available on-line in order to provide relevant comments. The ease with which the form can be completed on-line is critical to the success of the new system. We are concerned that firms will have to expend additional resources if the paper form does not match up with the on-line version. We understand that with respect to the current Form BD in the CRD system, the two versions (paper and electronic) are not identical, which is a source of confusion and lack of consistency in firm information and filing. We believe the Commission should

15 Interestingly, information disclosed by investment advisers about their firms and their employees is much more extensive and accessible to the public than the information clients receive from broker-dealers and their agents. Broker-dealers are not required to disclose fully all conflicts of interest, business practices, and policies and procedures on Form BD and are not required to provide Form BD to clients.

16 *See* Release at 14.

identify and clarify any discrepancies between the paper and electronic versions of Form ADV.

C. Disciplinary History

We commend the Commission for incorporating requirements of Rule 206(4)-4 into the brochure. Clients generally consider disciplinary history in making decisions about their adviser and clients should have access to this information. We are concerned, however, that the disciplinary history required is unnecessarily detailed and repetitive across various parts of the form. We do not believe that Form BD and its accompanying DRPs should be used as models for investment adviser disclosure. Further, some questions are overly intrusive and irrelevant, particularly those requesting information about charges that did not result in findings of guilt or liability. Our item-by-item commentary on these questions is provided in the relevant appendices.

The SEC has requested comment regarding whether disciplinary information should appear in a separate document.[17] We strongly believe this information should *not* be required in a separate document. The logistics involved in delivering three or more documents (brochure, disciplinary history, one or more supplements) as well as the recordkeeping requirements would be extremely complicated. In addition, clients know to look for disciplinary history. The table of contents required by the proposal would immediately direct clients' attention to the correct location.

The Commission has also requested comment on whether SEC-registered advisers should be required to report arbitration liability in excess of $2,500.[18] We believe that requiring disclosure of arbitration claims or awards would be inappropriate. As the Commission points out, it is not always possible to identify arbitrations that reflect upon the integrity of the adviser, as opposed to arbitrations of commercial matters to which a large adviser, like any other corporation, may be subject. In any event, if such a disclosure requirement were adopted, the proposed disclosure threshold of "in excess of $2,500" whether that is the amount of the claim or the amount of the award, is too low. This *de minimis* amount may not be material even for a small state-registered adviser, much less a large adviser with substantial staff, clients, and assets under management.

D. State-related issues

In its description of the electronic filing system, the Commission implies that many states require an SEC-registered adviser "doing business" in the state to provide a notice filing.[19] In fact, however, all but four states require notice filings only if an

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17 Release at 48.

18 Release at 51.

19 Release at 9 n.14; General Instructions, Item 8 at pp. 4-5.

adviser has a place of business in the state or more than five clients in that state.[20] We believe that the Coordination Act was intended to and did codify that *de minimis* requirement for notice filing. In any event, we anticipate that federal legislation currently under consideration will confirm that intent. We respectfully request that the final release correctly describe the states' notice filing requirements.

In the General Instructions for Part 2 of Form ADV, instruction number 5, the Commission asserts that for notice-filers, the "*state securities authorities* require you to send them paper copies of your *brochure* until the IARD system is capable of accepting these filings." This explanation should read that states "*may* require" such filings. Under the Commission's proposal, each state may determine whether or not to require paper filings during this period.[21]

In addition, the Commission proposes a rule amendment that would suspend preemption of a state's laws when the adviser registers with that state.[22] We understand the Commission's rationale for this proposal but caution against unintended consequences. Currently, some SEC-registered advisers may voluntarily register with a state because anachronistic pension laws in certain states require advisers to be registered with both authorities, despite the passage of the Coordination Act, and clients insist on complying with the letter of state law.[23] These advisers should not be subject to state regulation.

Finally, the Commission should note in Item 9 of the General Instructions that once an adviser registers with the SEC, it may withdraw its registration(s) from the state(s).

III. Part 1A

Part 1A will be the principal regulatory information-gathering form for the SEC. This part of the form has been greatly expanded. It incorporates most of the information requested in current Part I and also includes some information that is currently in Part II. The information requested in Part 1A is, for the most part, straightforward, and the Commission has included helpful instructions and a glossary of terms. Several questions, however, still ask for excessive or unnecessary detail, and the purpose of gathering the

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20 The definition of "notice filing" in the glossary and the description in Item 2B of Part 1A provide a more accurate statement of law and practice.

21 Similarly, in item 8(a) to the Instructions for Part 2A, the Commission asserts that "State laws require you to file paper copies of all *brochure* amendments with the *state securities authorities* to which you make *notice filings*." This statement is inaccurate. Some state laws, for example, currently require notice filers to file only page 1 of Form ADV annually.

22 Release at 19-20.

23 *E.g.*, Michigan Public Employees Retirement System Act, section 13(8)(a); Senate Bill 902, Oklahoma 2nd Session of the 47th Legislative Session (version date May 25, 2000) (to require advisers providing advice to school districts to be registered with the state).

information in this document is unclear. Our item-by-item commentary discussing these issues appears in Appendix A.

Further, proposed Form ADV frequently requests the same or similar information in multiple questions. For example, disciplinary history for certain personnel is disclosed in Part 1A and the DRPs and is repeated in the brochure and/or brochure supplement. The same wrap fee information requested in Part 1A is repeated in the brochure. This repetition is burdensome to the adviser and makes the disclosure documents too complex and unwieldy for clients. The SEC ultimately will receive both Part 1A and the brochure, and therefore should eliminate the duplication.

The Commission estimates that the average time an adviser will spend on creating Form ADV is 22 hours. We believe this estimate is low even for small firms and it is not *remotely* realistic for large advisers with a broad client base, expanded product lines, numerous affiliates, and complex policies and procedures. The required disclosures in both Part 1A and Part 2 regarding products, people, and policies per product will be proportionately greater the larger and more complex the organization. Particularly given the consequences of "inadequate" or inaccurate disclosure that could result in enforcement actions, any large complex organization will expend substantial resources on multiple layers of review and information-gathering, including review by outside counsel.

IV. Part 2: Delivery Requirements

Currently, each adviser must deliver its brochure or Part II of Form ADV at the inception of the advisory relationship and offer to deliver the brochure or Part II annually. At the same time, an adviser is required to update Form ADV either promptly or annually depending on the item to be amended. The updated Form need only be sent to clients that request the Form pursuant to the adviser's annual offer. We agree that the current system is ineffective, particularly because the vast majority of clients do not request the updated Form pursuant to the annual offer.

To address this problem, the Commission's proposal would require that advisers not only amend their brochures to reflect material changes, but also *deliver* a reprinted brochure or "sticker" to every client and prospective client every time the brochure is amended. Under the proposal, firms would also have to summarize separately the material changes in the brochure for clients and keep records of each summary and when it was delivered to clients. The proposal would also retain the current requirement of an annual offer.

We believe that public access via the Internet to the adviser's most up-to-date and complete Form ADV goes a long way toward improving the current situation. In lieu of the Commission's delivery/stickering proposal, we strongly recommend that Rule 204-3 be amended to require the annual *delivery*, not offer, of an adviser's current brochure to existing clients.[24] Delivery should be accompanied by prominent language disclosing

[24] We understand that some firms already deliver the brochure annually to all clients for better client relations and ease of recordkeeping.

that the brochure may be amended from time to time during the year, and that clients are advised periodically to check the listed website for any changes. We are confident that clients sophisticated enough to retain the services of a federally registered investment adviser have ready access to the Internet. The brochure could also be accompanied by a summary of material changes made to the brochure since the last delivery. The concept of an "offer" is no longer useful and should be eliminated. Of course, as is currently required, an adviser must provide *prospective* clients with its *most current* brochure filed with the SEC. Our proposal addresses only *delivery*, not filing requirements.

We understand and support the Commission's desire to keep clients apprised of material developments related to their advisers. We believe, however, that the Commission's proposals related to "stickering" and "summaries of material changes"[25] will be confusing to clients and overly burdensome for advisers. These proposals defeat the purpose of creating a continuously current electronic database available to the public. Our proposal of *delivering* a *clean* updated brochure to clients on an annual basis will accomplish the Commission's goals while improving the clarity of disclosure.

V. Part 2A

A. The Brochure Will Be Too Long and Dense

Part 2A requires all investment advisers to draft a firm brochure in a plain English, narrative format. In essence, it replaces information currently provided in Schedule F, the continuation page for current Part II of Form ADV. Advisers will provide narrative disclosure on 19 separate items. While the nature of the disclosure has been specified in the proposal, advisers generally will be free to structure the disclosure and order the topics so that it best conveys the required information.

We agree that the current "check-the-box" format is not user-friendly to clients. However, the proposed brochure is not merely reformatted but also requires a much higher level of detail regarding more topics than the current version. The brochure would have to include a firm's policies, practices, and procedures regarding the firm's business activities, ownership, fees, compensation, types of clients, methods of analysis, investment strategies, risks of loss, disciplinary information, financial industry affiliations and activities, personal trading, brokerage practices, soft dollars, commission recapture, allocation, account review, custody, wrap fee programs, investment discretion, proxy voting, performance advertising, and other financial information. While each item alone may sound reasonable, taken as a whole the rule appears to require advisers to prepare quite a substantial and detailed document that will be more than a "brochure." The requirements are even further complicated for large firms, where, for example, there may be different policies and procedures in various areas for each investment strategy.

Moreover, proposed Form ADV appears to require disclosure and delivery most relevant to financial planners and large wirehouses serving individual retail clients.

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25 *E.g.*, Release at 39, 129-130.

Unfortunately, these retail clients have no reliable way to assess whether the policies and procedures disclosed by advisers are effective or consistent with legal or professional standards.[26] Conversely, many of the proposed changes have limited relevance to the vast majority of institutional clients that typically are represented by sophisticated consultants. Through the RFP process, due diligence meetings, and the assistance of consultants, institutional clients are able to obtain as much detailed information about an adviser that they feel is necessary, including information about the individuals who will be managing their assets.

While we support the concept of a plain English brochure for clients, we believe the scope and extent of disclosure requested is excessive. The proposed brochure will be too lengthy and complicated for clients, particularly the type of retail client the Commission targets. Currently, *without* the additional items and detail proposed in the Release, many firms' Part II disclosure exceeds 10 or 20 single-spaced pages. The possibly unintended consequence of the proposal (especially with the "stickering" concept) is to transform the brochure into a mutual fund-like prospectus, which many investors will not read.[27] A narrative brochure that is likely to be in excess of 20 or 30 pages will not achieve its intended goal of providing clients with important information in an easy-to-read format.

B. <u>The Brochure May Create New Legal Obligations</u>

Investment advisers already make disclosures regarding many of the topics listed in proposed Part 2A. The Release, however, requires a new level of detail for each topic, as well as repeated requests for descriptions of policies and procedures. We are concerned that the requirement of policies and procedures for every potential issue that may conceivably arise implies a new regulatory regime that has never been properly proposed, reviewed, and approved. If so, this relatively short comment period is not sufficient to respond. Previously, the Office of Compliance Inspections and Examinations has urged investment advisers to adopt internal controls to give examiners confidence in the adviser and to streamline examinations (so-called "smart" exams).[28] It has not previously been suggested that advisers must have these policies and procedures in place as a matter of law. We are aware of no violation of law that would occur, absent other specific violations, based on lack of policies and procedures alone regarding any

[26] Clients' traditional lack of response to firms' annual offers may be evidence that clients do not feel this type of information is helpful.

[27] Indeed, the Commission created the concept of a "profile" prospectus for this very reason, and is in the process of deciding whether to eliminate the requirement that funds regularly deliver an updated prospectus to existing shareholders. *E.g. Success and Survival of the Mutual Fund Industry in a Changing World*, Remarks by Paul Roye, Director, SEC Division of Investment Management (May 19, 2000).

[28] The Commission has frequently accomplished "rulemaking" by inspection or enforcement actions. We oppose this method of regulation. For example, a few years ago, advisers did not describe their allocation or "bunching" policies in their Form ADV. We understand that the inspection staff at that time essentially "forced" advisers to start doing so through a wave of deficiency letters. This is not an appropriate means of informing the profession of new requirements.

particular topic (other than insider trading).[29] Should the Commission desire advisers to have such policies and procedures - for example, to adopt a code of ethics, a requirement the ICAA strongly supports[30] - it should propose regulations for comment in due course.

C. The ICAA Proposes An Alternative Approach

We propose an alternative approach to improve disclosure to clients. As is currently the rule, the Commission should require investment advisers to succinctly discuss potential conflicts of interest and certain other items listed in proposed Part 2A, but should not require details regarding the firms' policies and procedures for each topic. Instead, the adviser should prominently and explicitly offer to provide further information about the firm's policies and procedures to any client upon request. *We believe that a simple, clear 10-page document is all that a client would or should be expected to read.* In our item-by-item comments listed in Appendix B, we discuss areas in which disclosure could be streamlined.

To supplement and explain the information presented in firm brochures, the Commission could prepare an educational brochure for advisory clients, discussing in plain English potential conflicts of interest and suggesting questions to ask advisers or prospective advisers. The Commission recently issued such a booklet explaining variable annuities and suggesting questions to ask before investing.[31] The Commission has also created a web page entitled *Protect Your Money*, which advises prospective clients to obtain advisers' and brokers' disciplinary history and to ask advisers to deliver both Part I and Part II of current Form ADV.

We understand that the Commission believes that conflict of interest information is specific to each firm and hopes that disclosure will not be boilerplate. But realistically, some boilerplate is inevitable because certain potential conflicts of interest and policies are fairly common across the profession, necessitating similar disclosure.[32] Common issues that could be explained in the SEC's brochure include soft dollars, directed

[29] The only policy explicitly and affirmatively required of advisers by current law is an insider trading policy. Policies and procedures can constitute a safe harbor to a failure to supervise charge pursuant to Section 203(e)(5) of the Advisers Act. Many policies and procedures have implicitly been required or encouraged by no-action letters, interpretive releases, speeches by Commission staff, examinations, and enforcement actions. For example, while we support the Commission's proposed change to Rule 204-3 in the release at n.116, we note the apparently new announcement that a client can terminate the advisory relationship "at any time." Many advisers, however, have client contracts that currently provide for termination by either party upon 10 days or as many as 60 days written notice.

[30] *See* Letter of David G. Tittsworth, ICAA Executive Director, to Arthur Levitt, Chairman, Securities and Exchange Commission (May 16, 2000).

[31] *Variable Annuities: What You Should Know* (SEC web version dated June 5, 2000). *See also Mutual Fund Investing: Look at More Than a Fund's Past Performance* (SEC web version dated Jan. 24, 2000).

[32] The Commission implicitly recognizes this fact, by stating in the instructions to Part 2A exactly what the disclosure should include for certain topics.

brokerage, commission recapture, fees, compensation, personal trading, risk of loss, and custody.

Advisers could be required to provide the SEC's educational brochure to each prospective client. Or the Commission could display the brochure on its website and direct firms to alert clients to it. The ICAA would be pleased to assist the Commission in drafting such a booklet. The Commission's explanation of Part 2A in the Release already is a significant step in that direction.

VI. Part 2B

Part 2B is a newly required "brochure supplement." The Commission proposes to eliminate current Schedule D and instead require firms to provide each client with a supplement that describes the advisory personnel who (a) regularly communicate investment advice to *that client* or (b) formulate investment advice for *that client* (unless part of a team or committee) or (c) make discretionary investment decisions for the client's assets.[33] The intent is to provide a client with useful information about the employees relevant to that client, rather than general information about the executive officers or members of an investment committee of the firm. While this intent is laudable, we describe below its logistical difficulties, as well as alternative approaches. An item-by-item discussion of Part 2B as currently proposed is located in Appendix C.

A. <u>Part 2B is not feasible</u>

The brochure supplement concept may be well-tailored to small advisory firms, but is unrealistic and unworkable when applied to large organizations. In small advisory firms with only a handful of supervised persons, drafting, reviewing, delivering, and amending brochure supplements for a finite number of persons may be feasible. In larger organizations, however, it would be an administrative hardship to draft, deliver, and update brochure supplements for hundreds or even thousands of supervised persons, not to mention the obligation to track delivery of the supplements. For example, one client of a large investment adviser could have several portfolio managers for different market sectors providing advisory services to the account, several individuals communicating the portfolio managers' actions or investment advice to the client, and a marketing or relationship employee also in contact with the client. Thus, a firm could be required to send close to a dozen brochure supplements, in addition to a lengthy brochure, to one client.

Not only will large advisers have difficulty complying with the initial drafting and delivery requirements, but also with the continuing obligations proposed. Advisers will be obligated to send supplements for new employees servicing an account, sticker

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[33] Before the Coordination Act, advisers were required to provide information on Schedule D not only for management, investment committee members, and persons with disciplinary history, but also for persons "giving investment advice" on behalf of the adviser in particular states (item G). The latter requirement for Schedule D existed only for states' purposes. After the Coordination Act, advisers were no longer required to provide Schedule D information for persons only "giving advice" who did not fit any other category of required Schedule D filers.

existing supplements, and to maintain books and records to track delivery, offers, and amendments. The relatively frequent addition of a new portfolio manager or internal reorganization of staff will trigger several mailings. The administrative obligations alone would force extensive system changes to track which clients get which brochure supplements, when an offer to deliver was made, and when and which subsequent amendments or stickers were mailed – all on a client-by-client and employee-by-employee basis.

B. Alternative approaches are preferable

In support of the Commission's investor protection mandate, we suggest two alternative approaches to brochure supplements. We believe both of these approaches are more in line with operational realities than the current proposal, yet will still provide comparable investor protections and meet client needs. First, we recommend that investment advisers provide disciplinary information for all management and investment personnel in the brochure, proposed Part 2A. In the alternative, though less preferable, we suggest that the rule require investment advisers to deliver brochure supplements only to retail clients.

1. Expanded Part 2A

As an alternative to brochure supplements, the Commission should require important information be provided to clients about firm personnel in Part 2A rather than in a separate brochure supplement. Part 2A could be expanded to include disciplinary history for all employees who formulate advice for clients, not just for "management persons" as currently proposed.[34] The disciplinary history of other employees will already be available through the Internet both in Part 1A and in the Forms U-4 filed by "investment adviser representatives" with the states. The expanded disclosure in Part 2A could be coupled with a prominent offer to provide additional information not only about the persons formulating advice, but also about *any* employee involved in the advisory process. This could yield more information about more employees than is currently proposed.[35]

Of the seven disclosure items in the brochure supplements, disciplinary information is by far the most important to advisory clients, a position with which the Commission concurs.[36] Indeed, we believe that disciplinary history is more important and understandable to clients than the detailed policies and procedures proposed to be

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34 If this approach is taken, the requirement to disclose general educational standards should be re-inserted into the brochure. That disclosure is currently required in Item 5 of Part II.

35 For example, we understand that some sophisticated clients are requesting *and receiving* information about trading personnel of an investment adviser.

36 "The most important information in the supplements – the supervised person's disciplinary history – would be reported in the DRP Schedules in Part 1 of Form ADV and available through the IARD." Release at p. 68.

disclosed in the brochure. Under our proposal, the revised Part 2A disciplinary information disclosure item would require disclosure for all persons who determine or formulate general or specific investment advice, *regardless* of whether they are part of an investment committee. If disciplinary information for management and persons who formulate advice is included in the brochure along with a prominent offer to provide additional information upon request, we believe that clients will have the most vital information disclosed to them and access to any other information they deem necessary.[37]

The prominent offer of identified additional information could state in plain English:

> *Additional information on any employee of the firm involved in the advisory process is available, including educational background, business experience, additional business activities, and general compensation policies other than salaries. This additional information is available upon request by calling (   ) ___-____, emailing a request to ___@___ or by mailing a request to ____.*

Under this alternative, an advisory client would have immediate access to the most important disclosures – disciplinary information – for the most important advisory personnel – those persons deciding how to invest the client's assets. The client would also have available, upon request, additional information regarding employees involved in the advisory process.[38]

2. Brochure Supplements for Retail Clients

An alternative, though much less preferable, approach would be a requirement that brochure supplements be delivered only to retail clients – the type of client targeted by the Commission with the brochure supplement concept. Mandated disclosures are not necessary for sophisticated clientele, who often request specific information from investment advisers regarding advisory personnel. Providing brochure supplements to sophisticated clients will not significantly decrease the number and type of inquiries such clients pose to advisers, while greatly increasing the burden on advisers.

The ICAA strongly suggests that the Commission define retail clients as natural persons other than "qualified clients" as defined in Rule 205-3 under the Advisers Act. Thus, in general, retail clients would be natural persons who do *not* have a net worth of $1.5 million or $750,000 in assets under management of the adviser. Creating a dual standard for sophisticated clients and retail clients is consistent with other Commission

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[37] If the Commission chooses to make available an educational brochure for investors, as discussed above, it could emphasize the ability of clients to require and obtain information about any employee of the investment adviser involved in the advisory process.

[38] This system would work well for the vast majority of investment advisers that employ few, if any, persons with material disciplinary history. Perhaps firms that have a large number of disciplinary disclosures could have the alternative of using the Commission's proposed brochure supplement system so as not to render the brochure too lengthy.

rulemakings, such as the definition of “investment adviser representative” issued to implement the Coordination Act[39] and the rules governing performance fees.[40]

Similar to our first suggested approach, the brochure supplements should be prepared only for persons who actually formulate advice, including those who make discretionary investment decisions for clients. Many of these employees serving a retail clientele will fall under the definition of investment adviser representative and will be registered with the state securities commissions. Firms already have to prepare filings (Form U-4) for such individuals with the states. These filings include much of the same information that would be required in the brochure supplement. The Commission could permit firms to deliver Form U-4 to clients *voluntarily* in lieu of the supplement, so as not to require duplicative efforts.[41] This approach will provide retail clients with significant information about the persons providing them counsel.

[39] *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Rel. No. IA-1633 (May 15, 1997).

[40] *Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client’s Account*, Rel. No. IA-1731 (July 15, 1998).

[41] Of course, certain private information about the individual filing the U-4 would have to be blocked or deleted, such as any residential addresses or phone numbers, social security numbers, birth dates, and similar personal information.

CONCLUSION

In closing, we commend the Commission for issuing this historic proposal. This rulemaking encompasses perhaps the most significant changes in the investment adviser registration and disclosure regime since enactment of the Investment Advisers Act of 1940. With appropriate modifications, we are confident that the Commission's proposal will significantly enhance the level of relevant and useful information for investors, provide the Commission and the states with an unprecedented amount of data regarding individual advisers and the advisory profession, and allow investment advisers to achieve efficiencies in meeting their registration and notice filing obligations. We would be pleased to work with the Commission's staff in drafting language to modify appropriately the proposed revisions to Form ADV. Please do not hesitate to contact us if we may provide additional information or clarification to the Commission regarding any of these matters.

Sincerely,

KAREN L. BARR
General Counsel

Cc: The Honorable Arthur Levitt
The Honorable Norman S. Johnson
The Honorable Isaac C. Hunt, Jr.
The Honorable Laura Unger
The Honorable Paul R. Carey
Paul F. Roye, Esq.
Robert E. Plaze, Esq.
Marc D. Beauchamp

APPENDIX A
Specific Comments on Part 1A

Glossary

- We suggest that the term "material," which is used throughout Part 1A, be defined. Advisers could use further guidance in making these determinations.

Item 1 Identifying information

- *E*. The question should ask for *either* a CRD number *or* an IARD number or both. This change would also need to be made on the top of each page.

- *J.* We believe that information relating to the contact employee should not be made available to the public if it is only being requested for regulatory purposes. Is there a way to "protect" this information on the IARD?

Item 4 Successions

- The instructions here indicate that a firm should leave this item blank if it has already reported the succession on a previous filing. Leaving the item blank may cause a problem in the completeness check. We suggest that a firm in this situation be instructed to check the "no" box.

Item 5 Information about your advisory business

- *A and B.* The term "independent contractor" should be defined in the glossary of terms in the instructions. Who is the Commission trying to reach with this request? If the Commission is using IRS guidelines, it should so state. The Commission could also clarify that the term does not include persons who simply receive referral fees.

- *B(2).* We propose that the question about registered representatives be solely limited to employees because advisers currently are not required to track this information with respect to third party solicitors and other independent contractors. In any event, this information does not seem relevant or necessary even for employees.

- *D.* We suggest that the question about types of clients be eliminated. It is unclear what this data would be used for and it is difficult and time consuming for large investment advisers to categorize client accounts in this manner.

- *F(1).* The term "securities portfolios" should cross-reference the definition in Section 5.b.(1) of the instructions for Part 1A.

- *H.* The question about the number of financial planning clients does not seem important and should be eliminated.

- *I.* We strongly object to providing a list of all wrap fee programs and sponsors. This information may prove extremely lengthy and burdensome for firms with an extensive wrap fee business and may require somewhat frequent updating if the Commission deems this list material. We are certain that listing the programs and sponsors here will not eliminate a duplicative request for the same information, plus all related documents, from inspection staff during examinations.

Item 6 Other business activities

- *A.* Items A(2) and (7) are inapplicable to a firm and should be eliminated.

- *B(3).* This question will be difficult for an adviser to answer unless it is further clarified. If the adviser sells interests in a private investment company, should the adviser check "yes" or "no"?

Item 7 Financial industry affiliations

- The Commission should clarify why it has broadened the definition of "related person" to include persons providing investment advice on behalf of the adviser and what type of information it seeks to capture with the definition. More guidance is needed to apply the definition in the context of a wide range of firm structures.

- *A.* Questions (6) and (7) seem to call for irrelevant detail, *e.g.*, whether a person is a lawyer or accountant. Questions (9), (10) and (11) seem appropriate for Item 6 with respect to the adviser itself, but there is a high likelihood of error when extended to persons falling under (3) and (4) of the definition of related persons.

- *B.* This question calls for impossible detail when extended to persons falling under (3) and (4) of the definition of related persons. It is unclear what this data would be used for. In addition, we suggest that the question be limited to "investment-related" limited partnerships.

Item 9 Custody

- The Commission should clarify whether advisers with constructive custody need to answer this question and, if so, consider whether a "yes" answer here would cause confusion.

Item 11 Disciplinary information

- A firm is required to provide disciplinary information about advisory affiliates. The scope of the definition of "advisory affiliates" is unclear. We are particularly concerned about the universe of personnel who may be required to make these disclosures because the proposed Form ADV deletes the language excluding from the definition persons who perform "support or similar functions" found in current Form ADV. This deletion raises the question of whether persons functioning in professional capacities in a support role are included in the definition of advisory affiliate.

- Subsections A and B would require the firm or advisory affiliate to disclose any felony charge or a charge of any misdemeanor listed on item 11B(1). *We strongly object to the required disclosure of a charge that is not currently pending or did not result in a conviction or a guilty or nolo contendere plea.* Unfortunately, many individuals are charged with crimes they did not commit. These charges are often dropped promptly when the error is discovered or, in some cases, the person is fully acquitted by a court of competent jurisdiction. It is inappropriate to require disclosure of events of this sort. Any disclosure of charges that have not resulted in a conviction or a plea of guilty or nolo contendere should be limited to pending charges as currently required on Form ADV, Item 11G. We understand that the Commission may have proposed this question to conform Form ADV with Form BD. However, amending Form BD to eliminate this question is the more appropriate conforming action.

- We fully support limiting disciplinary history to 10 years. However, the directions that follow Item 11 should be moved to the beginning of this section. In its current location, it is unclear that a federally registered investment adviser does not need to disclose any event that is more than 10 years old.

- Item 11 and the DRPs should be clarified to permit removal of events that are resolved in the adviser's or advisory affiliate's favor after some disclosure has already been made. For example, an adviser would check "yes" in response to question H.(2) to report a pending proceeding. If the proceeding is later resolved in the adviser's favor, the adviser would check "no" in Part 1A; but the only options to check for removal of the disclosure in the Civil DRP are (a) because the affiliate is no longer associated with the firm or (b) because the event occurred more than 10 years ago.

Schedules A and B Direct owners and executive officers/Indirect owners

- *Schedules A/B*. The Commission should clarify whether advisers will have to list the enumerated relatives of any person with a greater than 5% ownership interest. If so, we do not understand why the SEC desires this information. Further, for simplicity, we suggest that the Commission incorporate these questions into the text of Part 1A, rather than in separate schedules. At a minimum, the two schedules should be combined.

- *Schedule A, 2(a)*. The phrase "and individuals with similar status or functions" may need further clarification to avoid uncertainty by the adviser as to which (other) individuals need to be reported. Perhaps "and individuals with similar status or functions exercising executive responsibility or presumed to have control" may provide more clarification.

- *Schedule A, 3*. Including the general definition of "indirect owners" under the question, as was done above in the second paragraph of 2(b) for direct owners, would be helpful. This will provide clarification in determining indirect owners and whether Schedule B must be completed.

- *Schedule B, 2*. The first sentence of this item should clarify that persons who meet the definitions in (a) through (d) are "indirect owners."

Schedule D

- We do not believe that Schedule D is necessary in an electronic environment. All information about one topic should be gathered in one location. Nor do we understand why the creation of multiple Schedules D is necessary. If Schedule D exists at all, the fields should be expanded to accept all information on one schedule. Otherwise large firms will be required to fill out numerous Schedule D pages.[42]

- *7.B.* We suggest that the question about the cost per unit of interests sold in the last year be eliminated. We understand that some limited partnerships are not offered in units, and also do not believe this information is needed here.

Execution pages

- Consistent with the intent of the Coordination Act, we suggest that the last sentence on the page authorize that records be made available to regulators only "as required by law."

- "Adviser CRD Number" should be changed to "Adviser IARD Number" on the execution pages.

[42] The same issue occurs with proposed Schedule W1 of Form ADV-W

APPENDIX B
Specific Comments on Part 2A

Item 1 Cover Page

- The instruction should clearly state that a change in the name and/or title of the contact person does not constitute a material change that triggers the requirement to reprint the brochure. Otherwise a contact person should not be required.

- References to CRD number should be replaced with IARD number.

Item 2 Material Changes

- Because an adviser is not required to provide a summary of material changes to a client or prospective client that has not received a previous version of the brochure, the summary should be a separate document.

- "Material changes" should be defined as changes that would significantly affect a reasonable client's decision to hire an adviser or a client's decision to retain an adviser.

Item 4 Advisory Business

- *B.* This item needs to better define "specialized" services. *See* Release at 43.

- *D.* The Commission should require a firm to use the same date and method for calculating the firm's assets under management as in Item 5.F. in Part 1A. The current proposal creates inconsistency and an opportunity for the adviser to select a particularly "good" month to display.

- *F(1).* We do not believe providing a list of all wrap fee programs and sponsors is meaningful information for a prospective client. For some advisers, this list could include dozens of items. If applicable, the adviser should state that it provides portfolio management services in wrap fee programs and that a list of sponsors is available upon request. In addition, we question why the adviser must repeat this information as the same information is requested at Item 5.I(2) in Schedule D.

Item 5 Fees and Compensation

- *C.* We agree that an adviser should describe generally how it is paid for providing advisory services. However, the Release goes much further, requiring an adviser "to describe the types and amounts (or ranges) of other costs, such as brokerage, custody fees, and fund expenses, that clients may pay in connection with advisory services." While it may be appropriate for the adviser to state that clients will incur additional fees and expenses in connection with the receipt of advisory services, and to describe the types of such fees and expenses, we do not believe it is appropriate for the adviser to conjecture what the amounts or ranges of these other possible fees or expenses might be when they are not charged by the adviser or within its ability to control.

- *E.* We assume the SEC does not intend this item to require disclosure of compensation paid to employees in connection with obtaining new advisory accounts. This information would be anti-competitive. Further, the adviser should not be required to disclose such information for the same reasons that Rule 206(4)–3 under the Advisers Act does not require a written disclosure statement to be delivered to a prospective client disclosing sales compensation paid to employees.

- *E.*1. This requirement appears excessive and repetitive. First, if the adviser or a supervised person of the adviser receives compensation for the sale of securities or other investment products, the adviser is told to explain that the practice represents a conflict of interest because the adviser or the supervised person has an incentive to recommend investment products based on the compensation received, rather than on the client's needs. The instruction also requires the adviser to describe its internal procedures or controls for addressing conflicts that arise, including any procedures for disclosing conflicts to clients. The adviser has already disclosed that the practice presents a conflict of interest situation and why it is a conflict of interest. It is unclear what additional disclosure the SEC expects the adviser to provide. In addition, this item may inadvertently imply that an adviser should not recommend its own investment products (*i.e.*, mutual funds or partnerships).

- *Performance Fees.* The Commission requests comment on whether to require performance fee disclosure.[43] We do not recommend such disclosure. Advisers already are required to provide disclosures in contracts with clients who will be charged performance fees. Such specific disclosures will be more meaningful than any general disclosure.

Item 7 Methods of Analysis, Investment Strategies and Risk of Loss

- *B.* The SEC should define what it means by "frequent trading of securities," as this term could be defined to mean day-trading, short-term trading (within 90 days), turnover of more than 100% per year, etc. The term "frequent" is also relative to the type of client and security traded. It seems obvious that a client will incur additional transaction costs (*e.g.*, brokerage commissions) with each additional trade.

- *D.* Practices regarding cash balances in client accounts vary so much depending on types of accounts and directions from clients that it is difficult to imagine that meaningful disclosure could be provided in response to this item.

[43] Release at 45.

Item 8 Disciplinary Information

- We do not recommend requiring that disciplinary information be provided in a separate written document accompanying the brochure. The disclosure and delivery requirements of new Form ADV are complicated enough with the stickers, supplements and DRPs, etc. without requiring yet another document.

- We agree that it would be in the adviser's best interests to prepare and maintain a memorandum memorializing the adviser's determination not to disclose an event described in this item.

- We strongly disagree with the proposal requiring an adviser to provide clients with a copy of an SEC administrative order unless the order itself required such distribution. As the Release indicates, the SEC has in some cases required an adviser to send copies of such orders to existing clients and for one year to prospective clients as a *condition of settlement* in administrative proceedings.[44] Such a requirement may very well be appropriate in the context of settling an administrative proceeding based upon the individual facts presented by the proceeding. A blanket requirement, however, is not appropriate and should not be included in Form ADV. In any event, disclosure of such an infraction may be deemed a "material" event requiring amendment or stickering of the brochure.

- While some disputes between advisory firms and their clients may be resolved through arbitration, such an action is not comparable to a felony or criminal conviction. As such, we do not believe it would meet the definition of a "disciplinary event material to evaluating the adviser's business or the integrity of its management." Thus, we do not recommend including arbitration actions in the brochure.[45] Parties are often assessed some liability for purposes of ending the dispute and coming to a resolution of the matter without any finding that the assessed party committed any wrongdoing. Also, because some arbitrators do not issue reports of their findings, it is difficult or impossible to distinguish arbitrations involving matters that reflect upon the integrity of the adviser.

- If the Commission does require arbitration disclosure, we recommend that disclosure be required only where the arbitrator finds a violation of an investment-related statute. Arbitration of commercial disputes, for example, is not relevant in this context. Further, a $2,500 threshold for such *claims* is substantially too low; if disclosure is required, the threshold should be a $50,000 *award* for SEC-registered firms.

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[44] Release at 50 and n.156.

[45] *See* Release at 51 (requesting comment on arbitration disclosure).

Item 9 Other Financial Industry Activities and Affiliations

- *C.* We agree that advisers should describe the nature of any conflicts involving relationships between the adviser or any management persons and any related persons. However, we do not agree advisers should be required to include detailed descriptions of all their internal procedures in their brochure. It is the adviser's responsibility to control and manage these conflicts.

Item 10 Participation or Interest in Client Transactions and Personal Trading

- We agree that advisers should describe the conflicts that arise when the advisory firm or a "related person" has a financial interest in, or trades in, securities they recommend to clients. However, we do not agree that the adviser should describe, other than in general terms, the controls or procedures it uses to control or manage those conflicts. To describe these procedures in detail would render the brochure unreadable. Indeed, the Release recognizes that many advisers have "extensive procedures" in place to monitor and control employees' personal securities trades and financial interests.[46] The SEC should clarify the amount of disclosure it expects with respect to the procedures it requests in each of these items. We also do not understand the stated requirement to disclose "procedures for disclosing conflicts to clients" - the brochure *is* the disclosure.

Item 11 Brokerage Practices

- *A.4.* We do not agree that advisers need to explain how commission recapture works.[47] Clients who instruct the adviser to direct their brokerage understand that they are going to receive benefits from the broker-dealer acting as custodian for their assets. Commission recapture does not present any conflicts of interest – the adviser does not receive any benefit in return for directing the brokerage for that client. All benefits inure directly to the client. We agree, however, that advisers should state whether they permit clients to request directed brokerage arrangements.

- Some of the disclosure required, in effect, may penalize small firms that may not be able to "negotiate" as much as larger firms with larger order flows.

- The Release should clarify its discussion of soft dollars to include execution services in addition to research, pursuant to Section 28(e).

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[46] Release at n.160.

[47] *See* Release at 60 (requesting comment on the commission disclosure requirement).

Item 14 Custody

- We agree that disclosure regarding actual custody should be included in the brochure. However, the Commission's position regarding "constructive" custody has been a longstanding source of confusion in the investment advisory community. We are disappointed that the Commission did not take this opportunity to clarify the circumstances under which an adviser is deemed to have custody. This item is particularly unclear because it implies that "special reports" are required if the adviser is deemed to have custody only because advisory fees are deducted directly from the account.

Item 16 Proxy Voting Policies

- We do not believe the adviser's brochure is the appropriate venue for discussing actual proxy-voting policies, practices and procedures. Such policies and procedures typically are very detailed (*e.g.*, matter-specific) and thus very lengthy. We believe, however, that advisers should state that their proxy voting policies and procedures are available upon request, as well as how the adviser voted during the year on behalf of the client.

- We agree advisers should disclose whether they have, or will accept, authority to vote proxies for clients and whether clients may instruct the adviser how to vote in a particular proxy solicitation. If an adviser does not vote proxies with respect to client securities, the brochure should so state. We also agree that an adviser should disclose how it would vote when there is a conflict between the adviser and the client regarding how to vote a particular item.

Item 17 Investment Performance

- We do not believe it serves any useful purpose for the adviser to disclose the standards it uses to calculate (or present) its investment performance in the brochure since the adviser already must disclose this information each time it advertises or reports the investment performance of managed accounts. In addition, this disclosure would be made in a vacuum because no performance information is presented in the brochure. This disclosure also may have the effect of endorsing or mandating use of the AIMR-PPS standards, with respect to which the SEC has officially taken no position.

- Similarly, the request about verification may have the effect of mandating costly verifications. If the SEC desires that effect, it should propose such a rule. Further, we do not believe it is relevant to clients "who" performed the third-party review of the adviser's performance information. We also do not believe clients are interested in the details of the review process.

Item 18

- This item should clarify that the balance sheet is not required under various no-action letters for certain circumstances involving constructive custody.

- We agree that an advisory firm's bankruptcy in the past ten years may be material to clients. The Commission requests comment on whether additional bankruptcy disclosure is necessary.[48] We do not believe disclosure would be material to clients regarding predecessor firms, management persons, or firms under common control with the adviser. If, however, the adviser is a sole proprietorship, bankruptcy information about the owner may be relevant.

Item 19

- Requiring both an index and a table of contents seems unnecessary and will clutter the document.

48 Release at 64.

APPENDIX C
Specific Comments on Part 2B

Instructions to Part 2B

- The Commission should clarify the instructions to Part 2B with respect to which employees an adviser is required to prepare and deliver brochure supplements. The release states that the supplement "is designed to require information about persons who have *substantial responsibility* for the investment advice clients receive."[49] In contrast, the first bullet of instruction 1 to Part 2B states, "You must prepare a supplement for each supervised person who on a regular basis communicates investment advice to a *client*."[50] Particularly in large firms, some persons who regularly communicate investment advice to a client do not have substantial responsibility for the advice the client receives. If the Commission does not accept our alternative approaches set forth at pp. 14-16, it should at a minimum not require supplements for persons who merely communicate or relay advice.

Item 1 Cover Page

- The brochure supplement would require cover page language directing clients to the IARD for additional information regarding the subject of the supplement. This statement incorrectly appears to assume that all persons for whom brochure supplements would be prepared are investment adviser representatives that have filed Forms U-4 with a state through the IARD. Many employees of large firms are not investment adviser representatives because, for example, they have an institutional clientele. The Commission should not require firms to imply incorrectly that a separate document is or should be available on the IARD for employees. We would not oppose a required reference to the IARD for information about the *firm*.

Item 3 Disciplinary Information

- This item requires brochure supplements to contain disclosures of *proceedings* revoking or suspending a professional attainment, designation, or license. Because *proceedings* is a defined term that is limited to formal administrative or civil actions initiated by a governmental agency, SRO, or foreign financial authority, this item would not capture revocations or suspensions by the entities that grant designations, *e.g.*, the Investment Counsel Association of America (CIC), the Association for Investment Management and Research (CFA), etc. Further, this item may require unintended disclosures, such as the revocation of a driver's license.

- If, however, the Commission intends to require disclosure regarding actions of a non-government designating authority, we oppose this provision. Without auditing all of

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[49] Release at 69.

[50] *Part 2B of Form ADV: Instructions for Preparing a Brochure Supplement.*

the designating authorities, the Commission cannot be certain that procedural, or due process-like, safeguards are in place to guard against abuses. We do not think it is wise to have peer-review actions as a required disclosure in Form ADV. Further, if the activity that leads to the suspension or revocation of a designation is egregious, a government entity typically will have taken action against the person, triggering reporting through a different subpart to Item 3.

Item 4 Other Business Activities

- *B.* We oppose the required disclosure of "any business or occupation for compensation." This item would require disclosure of any other business activities, even though they are not material to clients. For example, if a supervised person referees high school basketball games in the evenings, he or she would be required to disclose this occupation. This item should be rephrased such that disclosure of other business activities – not already required to be disclosed pursuant to 4.A – is only required if the other activity is investment-related or provides the primary source of the supervised person's income.

Item 6 Investment Advice and Supervision

- Item 6 requires disclosure of the title and telephone number of the person responsible for supervising the employee's advisory activities. Keeping this disclosure up to date will result in frequent stickering or updating of the brochure supplement. Further, a firm contact person and phone number may be required on the front cover of the brochure, making this an unnecessary requirement. We request that the Commission eliminate this item.

Item 7 Financial Information

- Item 7 requires disclosure if the employee has been the subject of a bankruptcy petition during the past ten years. The Commission is also requiring disclosure of firm bankruptcies in the brochure. Other than for sole proprietors, a personal bankruptcy will have no effect on an investment adviser's ability to meet client commitments, and thus should not have to be disclosed in the brochure supplements. Disclosure of such items may also defeat the bankruptcy laws' purpose of permitting individuals a "clean" start.

July 10, 2000

Mr. Ivan Strasfeld
Director of Exemption Determinations
Pension & Welfare Benefits Administration
Office of Exemption Determinations
U.S. Department of Labor
Room N-5649
200 Constitution Avenue, N.W.
Washington, D.C. 20210

Re: Joint Submission in Support of Active Cross-Trading Exemption from Section 406(b)(2) of ERISA

Dear Mr. Strasfeld:

Earlier this year the Department of Labor (Department) held hearings on whether to allow actively managed funds to cross-trade pursuant to a general exemption from Section 406(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) - Prohibited Transactions.[1] Such an exemption would apply only to actively managed pension funds that voluntarily agree through their independent plan fiduciaries to participate in cross-trading activities.

Representatives of each of the organizations signing this submission testified at the hearings in favor of an exemption for active cross-trades; that is, securities cross-traded for actively managed pension funds. These organizations are: the Association for Investment Management and Research (AIMR),[2] the Investment Company Institute (ICI),[3] the Investment Counsel Association of America (ICAA),[4] and the Securities Industry

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1 Hearing on Cross-Trades of Securities before the Department of Labor, Pension and Welfare Benefits Administration, February 10-11, 2000.

2 The Association for Investment Management and Research (AIMR) is a global, not-for-profit organization of more than 42,000 investment professionals in 95 countries. Through its headquarters in Charlottesville, Virginia, and more than 94 Member Societies and Chapters throughout the world, AIMR provides global leadership in investment education, professional standards, and advocacy programs.

3 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,084 open-end investment companies ("mutual funds"), 479 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.879 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

4 The Investment Counsel Association of America (ICAA) is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association’s membership today consists of more than 260 investment advisory firms that collectively

Association (SIA).[5] Our collective membership represents a substantial portion of all investment and related services provided to ERISA plans.

During the course of the hearings, the Department panel members posed several common questions to those testifying on behalf of the organizations mentioned above. This letter supplements our respective hearing statements by addressing two of the issues posed by the panel: (1) the respective duties of plan fiduciaries versus investment company directors, and (2) what cross-trading information plan managers should disclose to plan fiduciaries under a class exemption.

COMPARISON OF DUTIES OF PLAN FIDUCIARIES AND INVESTMENT COMPANY DIRECTORS

At the hearing, the Department suggested that application of the U.S. Securities and Exchange Commission (SEC) disclosure rules for cross-trades might not be appropriate for ERISA accounts, because ERISA plan fiduciaries and investment company boards of directors ("directors") are not similarly situated. Specifically, the Department suggested that directors have better resources or capabilities than plan fiduciaries with which to review cross-trading records provided to them.

Section (a) of this letter describes the legal standards applicable to directors and ERISA plan fiduciaries. Section (b) discusses and proposes a sophistication test for plan fiduciaries. In brief, both directors and plan fiduciaries are held to similar duties of care and loyalty with respect to actions taken on behalf of the investment company and its shareholders or the plan and its participants. We believe that the use of a sophistication test for plan sponsors wishing to enter into a cross-trade program could provide additional comfort that plan fiduciaries have the requisite sophistication, resources, and expertise to monitor cross-trade transactions executed on behalf of the plan.

A. Legal Standards for Investment Company Board of Directors and Plan Fiduciaries

1. Investment Company Board of Directors

In addition to certain specific obligations imposed by the Investment Company Act of 1940 ("1940 Act"), directors are held to legal standards under state corporation and

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manage in excess of $2 trillion for a wide variety of institutional and individual clients. For additional information, please consult the ICAA web site at www.icaa.org.

[5] The Securities Industry Association (SIA) brings together the shared interest of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates in excess of $300 billion of revenues yearly in the U.S. economy and employs approximately 700,000 individuals. More information about the SIA is available on its home page: http://www.sia.com.

business trust law. Although some of the responsibilities of a director may vary from state to state, or may vary because of the nature of the legal entity (for example, depending upon whether the investment company is organized as a corporation, business trust or limited partnership), state law generally imposes two fundamental responsibilities on each director: a duty of care and a duty of loyalty.

The duty of care requires that a director act with the degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position and in a manner that he or she reasonably believes is in the best interest of the investment company. The duty of care requires that a director obtain adequate information concerning matters he or she is called upon to decide and exercise his or her business judgment with respect to matters on which the board is expected to act. Under the "business judgment rule," a director is protected from liability for his or her decisions, so long as the director (1) acted in good faith; (2) was reasonably informed; and (3) rationally believed the action taken was in the best interests of the company.

The duty of loyalty requires that a director act in good faith, avoid unfair dealing, and resolve conflicts of interest in favor of the investment company and its shareholders. The duty of loyalty prohibits a director from engaging in business competition with the investment company or from obtaining any unfair gain from the investment company's operations. In addition, the duty of loyalty prohibits a director from converting to his or her own personal benefit opportunities that properly belong to the investment company.

In the context of cross-trading, Rule 17a-7 under the 1940 Act requires that investment company directors review a fund's cross-trades at least quarterly. In conducting these reviews, the directors are bound by the duties described above.

2. ERISA Plan Fiduciaries

Under ERISA's fiduciary duty rules, plan fiduciaries are subject to a prudence rule and an exclusive benefit rule. ERISA requires plan fiduciaries to perform all duties with the level of care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. ERISA defines a prudent fiduciary as one who: considers all available alternatives; evaluates all the facts on each potential course of action, investment or investment strategy; considers how the proposed action, investment or investment strategy fits into to overall goals of the plan; and obtains the best value for all services supplied to the plan. This requirement parallels the duty of care standard applicable to directors.

Under the exclusive benefit rule, plan fiduciaries must act solely in the interests of, and for the exclusive benefit of, the plan participants and beneficiaries. The exclusive benefit rule is a codification of the common law duty of loyalty. A plan fiduciary must avoid conflicts of interest that might affect its ability to make decisions on behalf of the plan and its participants and beneficiaries.

3. Application to Cross-Trades

In deciding whether to permit cross-trades, and in reviewing cross-trades involving a mutual fund or a pension plan, directors and plan fiduciaries would both be subject to the duty of care/prudence and the loyalty/exclusive benefit standards with respect to fiduciary activities. This would require directors and plan fiduciaries to, among other things, receive requisite information regarding the cross-trades and to review information solely on the basis of whether the cross-trades were in the best interests of the particular mutual fund or plan. In the past, the Department has provided exemptive relief for agency cross-transactions where the investment manager has discretion over only one side of the transaction. The Department conditioned this exemptive relief on regular disclosure of cross-trade information. In Prohibited Transaction Class Exemption 86-128 (PTE 86-128), the Department required the investment manager to provide the authorizing plan fiduciary with certain detailed reports regarding the cross-trade transactions either within 10 days of the transaction or quarterly.[6] Thus, in PTE 86-128, the Department recognized that the authorizing plan fiduciary would be capable of reviewing this disclosure information to determine whether the transactions are in the best interests of the plan.

B. Sophistication

At the hearing, the Department voiced its concern that plan fiduciaries might be less sophisticated than mutual fund directors and, thus, less able to conduct an adequate review of information provided regarding cross-trades. As discussed above, plan fiduciaries and fund directors have substantially similar duties and are obligated to fulfill them using appropriate means. For example, plan fiduciaries often retain consultants to help them assess performance and trading activity for the plan portfolio. Nevertheless, in order to address the Department's potential concern, various witnesses at the hearing suggested that the Department impose a sophistication test for plans engaging in cross-trades. Historically, the Department has used assets under management as a proxy for sophistication.[7] A cross-trade exemption could be limited to plans with greater than a certain amount in assets to ensure that the plan sponsor has the requisite sophistication and expertise to engage in a cross-trade program. These plan sponsors may also have more resources available to assist them in fulfilling their duties.

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[6] PTE 86-128 requires the investment manager to provide the authorizing plan fiduciary with either: (1) a confirmation slip for each cross-trade of securities within 10 business days of the securities transaction containing information described in Rule 10b-10(a)(1-7) under the Securities Exchange Act of 1934; or (2) at least once every three months, a report disclosing a compilation of the information that would have been provided to the plan if individual transaction confirmations had been delivered during the three-month period. In addition, the plan fiduciary must receive a summary at least annually that identifies the total number of cross-trades during the period and includes a description of the manager's brokerage placement practices if such practices have materially changed during the period.

[7] *See, e.g.*, PTE 84-14, 49 Fed. Reg. 9494 (Mar. 14, 1984); PTE 96-23, 60 Fed. Reg. 15597 (Mar. 24, 1995).

The prudence standard in ERISA section 404(a)(1)(b) requires fiduciaries to have the level of knowledge appropriate to the nature of the particular plan or its investments. In other contexts, the Department has recognized that certain types of plan investments may require a greater degree of sophistication on the part of plan fiduciaries. For example, in a letter describing fiduciary guidelines for the investment of plan assets in derivatives, the Department indicated that certain plan investments "may require a higher degree of sophistication and understanding on the part of plan fiduciaries than other investments."[8]

Therefore, ERISA's prudence standard in conjunction with an asset-based sophistication test would help ensure that a plan fiduciary would have the level of sophistication necessary to monitor the cross-trade transactions executed on behalf of the plan. Moreover, as noted above, the Department recognized that certain plan fiduciaries have the requisite sophistication to review and monitor agency cross-trades in granting PTE 86-128.

PROPOSED DISCLOSURE TO CLIENTS REGARDING CROSS-TRADE TRANSACTIONS

This section sets forth proposed reporting and disclosure requirements that would enable plan fiduciaries to monitor active cross-trades. We provide below recommendations for (a) a prototype list of required quarterly disclosures for plan fiduciaries, (b) a list of disclosures to be provided upon the plan fiduciary's request; and (c) record-keeping requirements. Appendix A contains a "mock-up" of a quarterly cross-trade report. This proposed disclosure would be in addition to, and would not replace, the information received by plan fiduciaries on confirmation slips for each transaction pursuant to Rule 10b-10. Rule 10b-10 information includes, but is not limited to, the date and time of transaction, the identity, price, and number of shares or units of the security, and other specific data in the case of transactions in certain debt securities.

[8] Letter from Olena Berg, Assistant Secretary Pension and Welfare Benefits Administration, U.S. Department of Labor, to Eugene Ludwig, Comptroller of the Currency (March 21, 1996).

A. Required Quarterly Reporting and Disclosures

An investment manager engaging in cross-trades should be required to provide a quarterly report to the plan's fiduciary detailing cross-trades entered into on behalf of the account during the prior quarter. Such a report would enable plan fiduciaries to monitor whether the cross-trades were in the best interest of the plan and whether the trades show patterns indicative of possible abuse. Plan fiduciaries could request additional information (see part B below) should they have any concerns or questions. We suggest that each quarterly report include the following information:

- the trade date;
- the name of issuer/security;
- the type of transaction (sale or purchase);
- the principal amount;
- the number of shares;
- the price;
- the basis for the price;
- the high and low prices of the security on the date of the cross-trade; and
- a certification regarding compliance with the firm's procedures.

B. Disclosures Provided Upon Request

A plan fiduciary should be able to request additional information from its investment manager regarding any cross trade entered into on the plan's behalf. This information could include the following:

- the generic type of counter-party (such as individual, fund, or partnership);
- the percentage of the plan's trades that were cross-trades;
- the justification for the cross-trade;
- any other relevant information reasonably available on the cross-trade.

C. Record-Keeping

Managers participating in cross-trades should retain written records for each trade for six years from the end of the fiscal year in which the cross-trade occurred. Managers should be required to supply the information contained in the records if requested by the plan fiduciary or by an authorized Department representative.

SUMMARY AND CONCLUSION

We believe there is compelling evidence that there are adequate safeguards and remedies available to pension funds should they decide voluntarily to engage in active cross-trades. Section 404 of ERISA and numerous federal and state laws and regulations already offer effective deterrents and means of redressing fiduciary conflicts and abuses. The proposed fiduciary sophistication test and cross-trade disclosure requirements would help ensure that (1) the plan fiduciary's knowledge and expertise is adequate and (2) the fiduciary has the necessary information available to review each trade and to identify potential questionable trading patterns. Proscription is not an appropriate standard to apply to transactions when they clearly stand to benefit the vast majority of ERISA plans and when adequate means exist to detect and prosecute any malfeasance.

In light of all the information presented - here, at the hearings, and in prior written submissions - we urge the Department to adopt a class exemption for cross-trading by actively managed accounts. Thank you for your consideration of this important matter.

Very truly yours,

Patricia Doran Walters, CFA
Vice President, Advocacy
Association for Investment
Management and Research

Craig S. Tyle
General Counsel
Investment Company Institute

Karen L. Barr
General Counsel
Investment Counsel Association
of America

Stuart J. Kaswell
General Counsel
Securities Industry Association

cc: Leslie B. Kramerich, Esq.
Alan D. Lebowitz, Esq.
Michael Schloss, Esq.
E.F. Williams, Esq.
Gerald T. Lins, Esq.
Mark F. Kemper, Esq.
R. Charles Tschampion, CFA
Michael S. Caccese, Esq.

Appendix A
Cross-Trade Disclosure Document

[Name of Pension Plan]
PTE __ Cross-Trade Transactions Report
For [date] to [date], [year]

Trade Date	Name of Issuer/ security	Principal Amount	Transaction Type	Shares	Price	High/Low Price	Basis
2/2/2002	IBM common stock	$515,000	Sale	5000	$103	$[x]	last sale price reported in consolidated system
ETC							

[Manager certification regarding compliance with firm's procedures]

August 17, 2000

<u>VIA ELECTRONIC MAIL AND U.S. MAIL</u>

Ms. Mary Jurta, CPA
Chair, NASAA Investment Adviser Model Rules Project Group
New Hampshire Bureau of Securities Regulation
State House, Room 204
Concord, New Hampshire 03301-4989

Re: *Proposed Amendments to the Uniform Securities Act and the NASAA Model Rules Concerning the Implementation of IARD*

Dear Ms. Jurta:

The Investment Counsel Association of America (ICAA)[1] appreciates the opportunity to comment on NASAA's proposed amendments to the Uniform Securities Act of 1956 and NASAA model rules thereunder to implement the Internet-based Investment Adviser Registration Depository (IARD).

The ICAA applauds NASAA and the SEC for developing the IARD. When fully implemented, the system will enable SEC-registered investment advisers to electronically register with the SEC and to submit notice filings and fees to the states on a one-stop Internet-based system. At a later date, investment adviser representative registration filings will also be processed electronically. A true one-stop electronic filing system and depository will benefit state securities agencies, the SEC, the investment adviser profession, and investors.

The ICAA generally supports NASAA's adoption of the proposed amendments to the Uniform Securities Act of 1956 and NASAA model rules. We commend NASAA for issuing model language and strongly encourage the states to adopt the model amendments and rules uniformly and to accept filings through the IARD. Because the ICAA's membership consists solely of SEC-registered investment advisers, our comments are generally limited to provisions regarding notice filing for federally registered investment advisers (federal covered advisers) and registration of investment adviser representatives.

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[1] The ICAA is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 270 investment advisory firms that collectively manage in excess of $2.5 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at <u>www.icaa.org.</u>

General Comments

As the memorandum accompanying the project group's proposed amendments notes, the SEC recently proposed amendments to the rules promulgated under the Investment Advisers Act of 1940 and to Form ADV.[2] The comment period on the SEC's release ended on June 13, 2000 and the Commission has not yet adopted final rules. As you know, the SEC's proposed rules are far-reaching and somewhat controversial as evidenced by numerous comment letters submitted by the profession, trade groups, and other interested parties.

In particular, many comment letters raised numerous concerns regarding the brochure (Part 2A), brochure supplement (Part 2B), and accompanying delivery requirements, and suggested alternative approaches for the SEC to implement.[3] The SEC staff has publicly indicated that the Commission will bifurcate the adoption of Form ADV, adopting Part 1 in early September and delaying the adoption of Part 2 until later this year.[4] It is therefore likely that the SEC will *not* have adopted Part 2 of Form ADV by the time NASAA votes on this proposal. Thus, we recommend that NASAA withhold consideration of rule 203(b)-1, *Investment Adviser Brochure Rule*, until the SEC has acted in order to conform the proposed amendments with the SEC's final rules.

We also wish to express our concerns with the apparent lack of progress by the states in ensuring universal participation in the IARD. One of the promises of the IARD is a one-stop filing system for the investment adviser profession. With fewer than two months before the pilot program becomes operational and fewer than six months before the system goes live, we are concerned that states may not have the necessary time to adopt and implement amendments to their acts and rules to fully participate in the new system. The proposed model amendments to the Uniform Securities Act and NASAA model rules are very positive steps, but the difficulty lies in getting all states, where necessary, to act upon these amendments as soon as possible. Anything but full participation by the states in accepting electronic notice filings and investment adviser representative registration filings from federal covered advisers will defeat one of the primary purposes of the IARD.

Specific Comments

- *Uniform Securities Act Section 202*

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[2] *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Release Nos. IA-1862, 34-42620 (April 5, 2000).

[3] The ICAA's comment letter to the SEC was submitted to the SEC in electronic form and is available on the SEC web site at www.sec.gov under "Current SEC Rulemaking" and "Proposed Rules." It is also available on the ICAA's web site under "Comments and Statements."

[4] *Commission to Wait on Release of ADV Brochure Requirements*, IA Week (July 24, 2000).

Under the Uniform Securities Act, as amended by NASAA, federal covered advisers are by definition excluded from the definition of investment adviser.[5] Therefore, electronic notice filings by a federal covered adviser with the state's designee and associated fee payments are not included in the proposed amendments to Section 202(a). We suggest that NASAA adopt amendments to Section 202(b) to permit a state to require federal covered advisers to notice file with its designee.

Suggested amendment:

Sec. 202(b) Except with respect to federal covered advisers whose only clients are those described in section 201(c)(2) of this act, a federal covered adviser shall file with the [Administrator] <u>or his designee</u>, prior to acting as a federal covered adviser in this state, such documents as have been filed with the Securities and Exchange Commission as the [Administrator], by rule or order, may require.

- *NASAA Model Rule 202(a)-A*

If NASAA amends section 202(b) above, the model rule should reflect the Administrator's authority to designate an entity to receive notice filings for federal covered advisers.

Suggested amendment:

Rule 202(a)-A(a). DESIGNATION. Pursuant to section 202(a) <u>and 202(b)</u> of the Act ... collect related fees from investment advisers<u>, federal covered advisers,</u> and investment adviser representatives…

(b) USE OF WEB IARD. Unless otherwise provided, all investment adviser<u>, federal covered adviser,</u> and investment adviser representative applications…

Consistent with the division of regulatory responsibilities between the SEC and the states under the Investment Advisers Supervision Coordination Act (Coordination Act), the decision on any hardship exemption for a federal covered adviser's notice filings and its investment adviser representative filings should be governed and processed according to the rules proposed by the SEC.

Suggested amendment:

(d)(3) Recognition of Exemption. The decision … where the investment adviser is registered. <u>The decision to grant or deny a request by a federal covered adviser for a hardship exemption will be made pursuant to the rules promulgated under the Investment Advisers Act of 1940. Such decision shall be followed by the [Administrator].</u>

[5] "Investment Adviser does not include ….. (6) any person that is a federal covered adviser." Uniform Securities Act, as amended, Section 401(f).

- *NASAA Model Rule 202(b)-1*

IARD is being rolled out in four stages through the end of 2001, the last of which will require investment advisers to submit electronic filings of Form ADV Part 2A (the brochure). While the SEC's proposal requires investment advisers to prepare the brochure and deliver it to clients before they have the ability to file it electronically, the SEC also indicated that it will not require investment advisers to make paper filings of brochures during the interim period between adoption of the final rule and the time IARD accepts brochure filings.

However, at the request of NASAA, the SEC proposed to deem the new brochures as filed with the Commission, indicating that state regulators could require federal covered advisers to make paper notice filings of the brochures.[6] The ICAA and others objected to this stop-gap measure because it adds an administrative burden to SEC-registered advisers with no investor protection benefit and no compelling regulatory rationale.[7] We remain optimistic that the SEC will ***not*** deem the brochure to be filed when it issues its final rules.

If the SEC's final rules do not deem the brochure to be filed with the Commission, NASAA proposed rule 202(b)-1(b) would be an impermissible state requirement under the Coordination Act. Pursuant to the Coordination Act, absent fraud or deceit, a state securities regulator may only require documents that are "filed" with the SEC.[8] We strongly recommend that NASAA withdraw consideration of this provision until the SEC has made a decision on whether to deem the brochure to be filed with them.[9]

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[6] "At the request of NASAA, we have included a provision in our proposed rules that a brochure be retained by the adviser would be considered 'filed' with us. As a result, until advisers submit Part 2A to the IARD, the state securities authorities could require SEC-registered advisers to file a copy of Part 2A (on paper) with them." *See supra* note 2, at page 23.

[7] "Requiring Part 2A on paper would be unnecessarily burdensome for firms already completely revising their Form ADVs and becoming familiar with the IARD. Further, Part 2A already must be provided to clients and prospective clients, so there is no investor protection rationale for the requirement. States will have all of the regulatory information they need in Part 1, including disciplinary history. We see no legitimate 'notice filing' need for states to require advisers manually to file a copy of Part 2A, particularly where it is a stop-gap measure until the IARD is completed." *Letter from Karen Barr, ICAA, to Jonathan Katz, Secretary Securities and Exchange Commission, on Electonic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Rel. No IA-1862, File No. S7-10-00 (June 13, 2000).

[8] Investment Advisers Supervision Coordination Act, Section 307(a).

[9] If, despite our objections, the SEC "deems" Part 2A to be filed with the Commission, the ICAA would not object to proposed rule 202(b)-1(b), which we interpret as providing a mechanism for a state to request, on a case-by-case basis only, a paper copy of a federal covered adviser's brochure. If NASAA adopts proposed rule 202(b)-1(b), the ICAA requests it to clarify the procedures for how a federal covered adviser would "agree" to provide Part 2A in paper. The proposal does not address how an investment adviser would consent to provide paper filings. The procedure would have to involve an electronic self-executing consent through IARD, because it would defeat the purpose of the provision to require federal covered advisers to file paper consents.

NASAA should also amend proposed rule 202(b)-1(d). We do not object to what we believe is the intent of the rule: to allow for a state to require federal covered advisers to submit amendments to Form ADV required by the SEC as part of the state notice filing requirement. However, as proposed, the rule goes beyond a state's authority under the Coordination Act by mandating how a federal covered adviser is required to file amendments to its Form ADV. A simple statement indicating that all amendments filed with IARD become part of the adviser's notice filing should be sufficient to incorpore SEC-required amendments to Form ADV into the state notice filing.

Suggested Amendment:

(d) <u>AMENDMENTS. The notice filing for a federal covered adviser includes all amendments to the federal covered adviser's Form ADV filed with Web IARD.</u>

- *NASAA Model Rule 203(d)-1*

The proposal requests comment on a June 30, 2001 target date for investment adviser representative filings. The ICAA believes that, at a minimum, a two-month window from the end of the SEC requirement for federal covered advisers to file Part 1 of Form ADV (April 30, 2001) is necessary for federal covered advisers to convert investment adviser representative filings to the IARD.

- *NASAA Model Rule 401g2-1*

The ICAA supports the proposed amendment to rule 401g-2-1 (Alternative Two) to incorporate the 1998 amendments adopted by the SEC to the definition of investment adviser representative. The amendments enable supervised persons of an investment adviser with a small number of institutional clients to take on a limited number of accommodation clients without becoming an investment adviser representative and are thus consistent with the SEC's amendments.

For further uniformity, the ICAA also recommends that NASAA amend the definition of investment adviser representative to include changes the SEC adopted in 1998 to the definition of "excepted person."[10] Excepted persons, as incorporated in NASAA model rule 401g2-1 and SEC rule 203A-3, are high net worth natural persons who do not count as natural person clients when determining whether a person is an investment adviser representative. When NASAA adopted model rule 401g-2-1, an excepted person was defined by the SEC as a natural person with $500,000 under management with the investment adviser or $1,000,000 in total assets. To account for inflation, the SEC has since adopted amendments raising the dollar figures to $750,000

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[10] *Exemption for Investment Advisers Operating in Multiple States; Revisions to Rules Implementing Amendments to the Investment Advisers Act of 1940; Investment Advisers with Principal Offices and Places of Business in Colorado or Iowa,* Rel. No. IA-1733 (July 20, 1998).

under management or $1,500,000 in total assets.[11] NASAA has not previously amended its definition to conform to this change.

To alleviate the necessity for states to promulgate new rules each time that the SEC amends the definition of investment adviser representative, the ICAA encourages all states to adopt Alternative One of rule 401g-2-1, which incorporates the SEC's definition of investment adviser representative by reference.

Fees

The SEC recently issued an order setting filing and updating fees for federal covered advisers to file Form ADV on the IARD.[12] Fees for investment adviser representative are not addressed in NASAA's proposal. This omission raises several questions. Are investment adviser representative filing fees for federal covered advisers incorporated into the processing fee established by the SEC's order? If there is a separate processing fee to file Forms U-4 and U-5, what is the fee structure? Is the fee based on a per amendment rate or is there an annual fee similar to the SEC's fee for Form ADV? Further, if there are separate investment adviser representative processing fees, where are the funds deposited and how are they used? Are these funds commingled with the audited account the SEC indicates it is establishing for Form ADV filing fees?

Conclusion

In closing, we commend NASAA and the project group for issuing model amendments and rules. We hope these comments are helpful and stand ready to assist in any manner necessary to insure the success of the IARD. Please do not hesitate to contact us if we may provide additional information or clarification on these issues.

Sincerely,

Daniel Kahl
Counsel

Cc: Melanie Senter Lubin, Esq.
Katy Davé, Esq.
Louis Cala
David Finnigan
Ron Peterson
Paul M. Schwartz
David Smith
Robert Plaze, Esq.

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[11] 17 CFR 270.205-3(d)(1).

[12] Designation of NASD Regulation, Inc. To Establish and Maintain IARD; Approval of IARD Fees, Rel. No IA-1888 (July 28, 2000).

September 25, 2000

Via U.S. Mail and Electronic Filing

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

Re: Revision of the Commission's Auditor Independence Requirements, Release Nos. 33-7870; 34-42994; 35-27193; IC-24549; IA-1884; File No. S7-13-00

Dear Mr. Katz:

The Investment Counsel Association of America appreciates the opportunity to respond to the Commission's request for comments regarding its proposed revisions to the auditor independence requirements.[1] We applaud the Commission's focus on the principle of auditor independence and we support the goals of the Commission's proposals.

As the Commission notes in its release, the accounting profession has been entrusted with the privilege and responsibility to audit the financial statements of publicly held companies.[2] Millions of individuals and entities - and investment advisers acting on their behalf - invest in the securities markets in reliance on financial statements issued by public companies. The attest function of the independent auditor provides investors and their advisers with the assurance that issuers' financial statements have been audited by an objective professional of competence and integrity in accordance with generally accepted accounting principles. Thus, the actual and *perceived* independence of auditors is critical to investor confidence in the capital markets.

We are concerned that consolidation of accounting firms as well as a movement in the profession beyond traditional accounting services may result in a public perception that auditors of financial statements may be subject to potential conflicts of interest. Accounting firms are now marketing themselves as multi-disciplinary service providers with numerous product lines and consulting services. According to the Commission,

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[1] The ICAA is a national not-for-profit association that consists exclusively of federally registered investment adviser firms. Founded in 1937, our current membership is comprised of more than 270 firms that collectively manage over $2.5 trillion in assets for a wide variety of institutional and individual clients.

[2] To satisfy this public trust, "the auditor must approach each audit with professional skepticism and must have a willingness and freedom to decide issues in an unbiased and objective manner, even when the auditor's decisions may be against the interests of management of an audit client." Release at p. 5.

auditing services that used to be the bread and butter of accounting firms provide only 30% of total revenues at such firms today, while management consulting services have skyrocketed. This dramatic trend has led to concern that the independence of auditors that report to management for whom they provide lucrative consulting services may be compromised. It is fair to question whether an auditor is able to review financial statements with a skeptical, inquiring eye - and firmly challenge management - in an environment of significant non-audit relationships. Even assuming auditors can remain truly independent in these circumstances, what is the public perception of the relationship? As Chairman Levitt recently stated:

> [A]uditors who also provide consulting services for their audit clients must now serve *two* masters: a public obligation to shareholders, and a professional duty to management. And when the two come into conflict, the independent audit – dwarfed by the more lucrative consulting businesses – may too often be compromised.[3]

Many in the accounting profession have countered that there is no evidence of abuse, that providing other services to auditing clients permits a better knowledge and understanding of the client, and that providing multiple services is more cost-effective to clients (some of whom are our members). We understand the relevance of these considerations, and we urge the accounting profession to work constructively with the Commission to achieve reforms that balance all of these considerations. A resolution in the public interest would only bolster the profession's reputation of integrity and trust.

We also take this opportunity to support strongly the Commission's proposal to reduce the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor. Current requirements unnecessarily limit investment and employment opportunities available to audit firm personnel and their families even where no potential conflict exists. Some of our members have reported that their employees are subject to unreasonable restrictions based on family relationships with employees of audit firms and that some employees have been forced to leave their jobs due to these restrictions. We commend the Commission for proposing to tailor its restrictions to those who actually work on or are closely connected with the audit, and request the Commission to consider further appropriate flexibility in these rules.

Thank you for considering our comments on this important issue. Please do not hesitate to contact the undersigned if we may provide any additional information.

Sincerely,

KAREN L. BARR
General Counsel

[3] *A Profession at the Crossroads*, Speech by SEC Chairman Arthur Levitt, before the National Association of State Boards of Accountancy (Sept. 18, 2000).

ICAA

2000 Activity Report

December 31, 2000

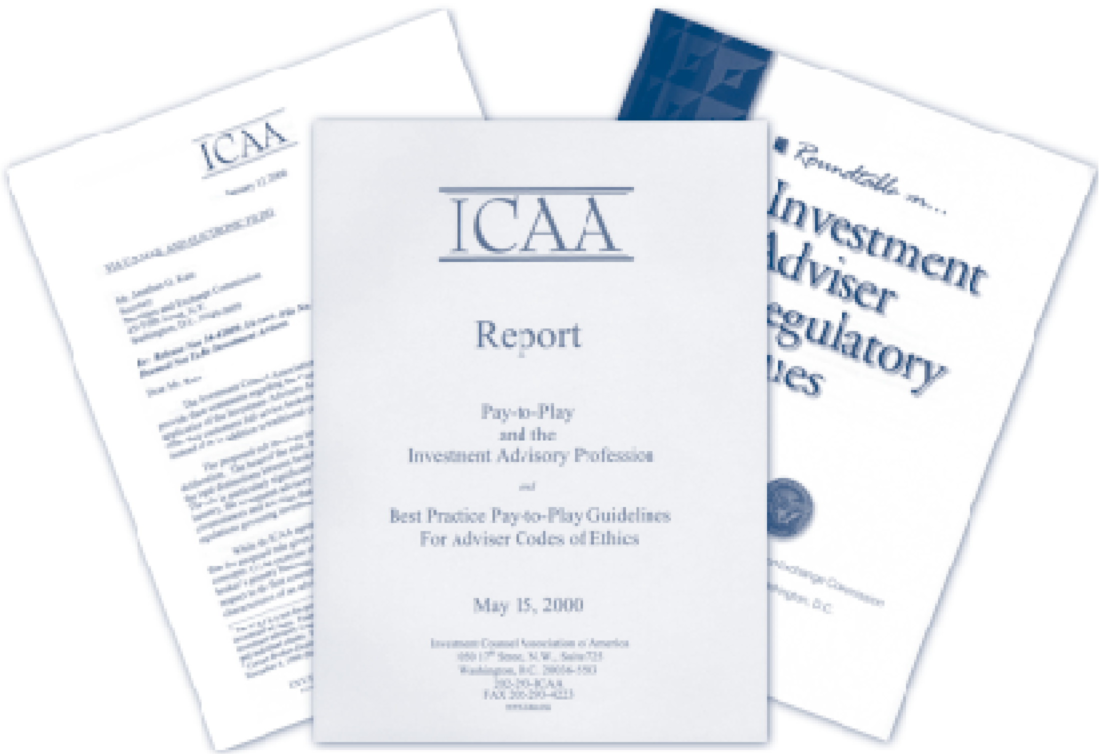
We are pleased to provide the following activity report to the membership. As indicated in this brief summary, 2000 was the most productive year in the long and distinguished history of the Investment Counsel Association of America.

The year 2001 will bring new challenges and offer new opportunities for the ICAA. We welcome your suggestions for improving the Association and invite your participation in the various activities of the ICAA.

We truly appreciate your continued support of the Association and look forward to working with all members as we strive to build on our record of service and excellence.

ICAA Board of Governors

Advocacy



The Association plays a critically important role as the leading representative and advocate for the investment advisory profession regarding legal, regulatory, and compliance issues. The ICAA is involved in a continuing dialogue with the SEC, the Congress, the Department of Labor, state securities regulators, and other industry organizations regarding every major initiative affecting the profession. Following is a chronological listing of some of the important initiatives and issues the ICAA has been involved with during the past year.

Advocacy

Any good investment adviser knows you can't afford to have compliance and regulatory problems. The ICAA is the best way to stay informed and on top of the rapidly changing legal and regulatory environment.

- In January, the ICAA filed written comments with the SEC regarding its proposed rule regarding the broker-dealer exception under the Investment Advisers Act and worked throughout the year with other industry and consumer groups to raise awareness of the issues involved. Issued in response to the announcement of Merrill Lynch's decision in 1999 to offer fee-based services, this important rulemaking could have profound implications for the advisory profession. A final regulation is expected early in 2001.

- In February, Mark F. Kemper (Brinson Partners, Inc.) testified on behalf of the ICAA before the Department of Labor regarding a proposed class exemption under ERISA to allow cross trading between actively managed accounts, citing numerous benefits to plan sponsors. The ICAA has repeatedly urged the Department of Labor to conduct hearings on the proposed exemption. The ICAA also filed written comments with the Department in support of a related class exemption for cross trades by index and model-driven funds.

- In March, the ICAA filed written comments with the SEC on its proposed privacy rules. Issued in accordance with the mandates of the Gramm-Leach-Bliley financial services modernization legislation passed by Congress late in 1999, the new privacy regulations were issued by the SEC in June and require investment advisers and other financial services providers to have privacy policies and procedures in place by July 1, 2001. The ICAA's compliance workshops, conducted in October and November, included a discussion of the new regulations. The ICAA will offer continuing guidance to its membership on these new rules.

- On May 15, the ICAA released a report, entitled "Pay-to-Play and the Investment Advisory Profession," which includes best practice guidelines for adviser codes of ethics. This important report outlines issues involved in the SEC's proposed rule prohibiting pay-to-play activities by advisers to public pension plans and highlights differences between the investment advisory profession and the municipal securities industry. In a press release issued on May 16, SEC Chairman Arthur Levitt stated: "The report and recommendations are important steps toward preventing pay-to-play abuses in the investment advisory industry and indicate that the industry is serious about addressing these problems. I commend the ICAA on this important initiative. Working together, the SEC and the advisory industry can help to eliminate the abusive practices that undermine the integrity of the investment adviser selection process. The ICAA's report gives us a number of recommendations to consider as we craft a final rule to eliminate pay-to-play abuses in the industry." A final rule is expected in the near future.

- On May 23, the ICAA was an active participant in the historic roundtable on investment adviser regulation convened at the SEC's headquarters in Washington, D.C. ICAA Executive Director David Tittsworth filed an extensive written statement and testified at the roundtable, outlining the virtual revolution that is occurring in the SEC's regulatory, inspection, and enforcement programs governing investment advisers and emphasizing that a self-regulatory organization for advisers would be burdensome and unnecessary. Representatives of ICAA member firms, including Henry H. Hopkins (T. Rowe Price Associates, Inc.), Sandra P. Tichenor (Loomis Sayles & Company, L.P.), Mary Ann Tynan (Wellington Management Co., LLP), Kathryn L. Quirk (Scudder Kemper Investments, Inc.), Luis Aguilar (INVESCO, Inc.), Thomas M. Mistele (Dodge & Cox), and Jilaine H. Bauer (Heartland Advisors, Inc.), also testified at the roundtable on a range of issues facing the advisory profession.

- In June, the ICAA filed extensive written comments with the SEC in response to its proposed rules revising Form ADV and establishing the Investment Adviser Registration Depository (IARD). This action was a continuation of the Association's long-standing involvement in these important initiatives, including its participation on the IARD Advisory Council, established by the SEC and the states to address a variety of issues pertaining to the IARD. In September, the SEC issued final rules on Form ADV, Part 1 and established a schedule for electronic filings. Numerous ICAA member firms participated in the SEC's pilot program during the past several weeks, helping to identify and correct potential problems with the new system. The ICAA's compliance workshops held in October and November provided the latest information on Form ADV revisions and the IARD. It is expected that the SEC will issue final regulations on Form ADV, Part 2 in the near future. The Association will continue to provide information and assistance to its firms on these important issues as developments occur.

- In July, the Senate Committee on Banking, Housing and Urban Affairs, chaired by Sen. Phil Gramm (R-TX), passed the Competitive Market Supervision Act. The bill includes provisions supported by the ICAA to address problems that have arisen in a few states since enactment of the Investment Advisers Supervision Coordination Act in 1996 (the watershed law that generally preempts state regulation of investment adviser firms with more than $25 million in assets under management). The ICAA will continue to work with Senator Gramm and other Members of Congress during the coming year to promote efforts that will reduce unnecessary and burdensome regulation of SEC-registered advisers by the states.

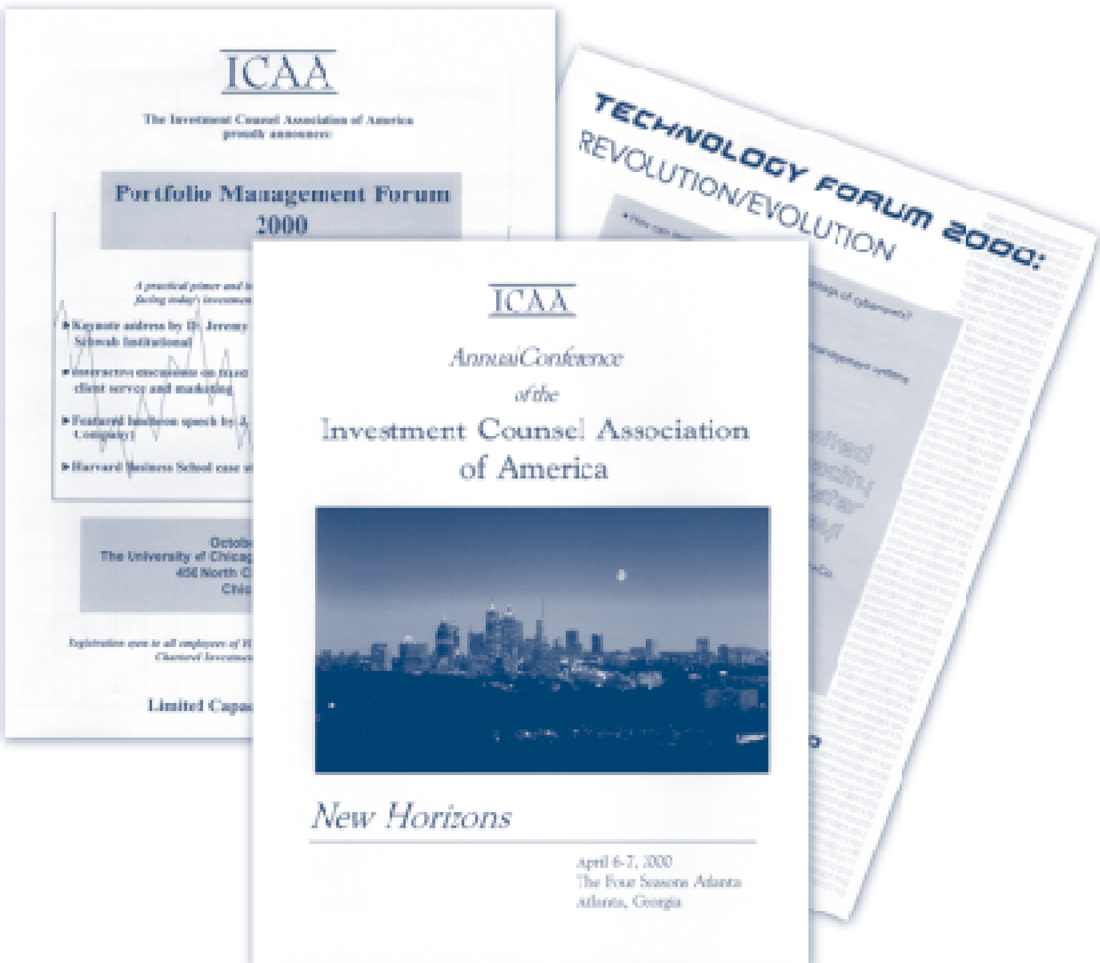
- In August, the SEC issued Regulation FD (fair disclosure), addressing the selective disclosure of material nonpublic information by public companies. The ICAA's Legal and Regulatory Committee is evaluating and monitoring this significant new rule to determine whether it will result in a deterioration of quality information to analysts and investors, hinder communication between issuers and analysts, promote market volatility, or have other adverse effects.

- In September, the ICAA filed written comments on the SEC's proposed rules regarding auditor independence, supporting the goals of the proposal and urging the Commission to work with the accounting profession and other interested parties to achieve a balanced rule. In November, the SEC adopted a final rule that modernizes and revises its rules for determining whether an auditor is independent.

- In December, the ICAA filed written comments with the SEC in response to a proposal by NASD Regulation regarding the ability of mutual funds to advertise related performance. In addition, the ICAA's Legal and Regulatory Committee and Performance Advertising Committee are working to identify ways to improve, update, and consolidate regulations related to advertising by investment advisers.

- During the past year, the ICAA has worked diligently with the National Conference of Commissioners on Uniform State Laws and the North American Securities Administrators Association to promote uniform state securities laws and regulations pertaining to investment advisers. In addition, the ICAA wrote various comment letters, provided information, and participated in hearings by the Texas Sunset Commission in a continuation of efforts designed to address regulations of the Texas Securities Board that run afoul of the 1996 federal law.

Education



The ICAA conducted an unprecedented number of conferences and other meetings during the past year in an effort to keep our members fully informed about relevant issues that affect the investment advisory profession and to provide a forum for our members to network and discuss matters of mutual concern. These conferences and meetings are provided to our membership at very reasonable rates and are an important benefit of ICAA membership. Assuming the ICAA continues to increase its membership and resources, the Association will be able to offer an expanded range of educational benefits to serve an increasingly diverse membership. Following is a brief summary of some of the educational events the ICAA sponsored during 2000.

Education

One of the most valuable benefits of belonging to the ICAA is the ability to

discuss today's issues with other leaders in the investment advisory profession.

- In April, the ICAA held its annual conference in Atlanta. Entitled "*New Horizons*," the program featured presentations by Abby Joseph Cohen, Jeremy Grantham, Hon. Griffin Bell, Charles Brady, Paul Roye, and other distinguished speakers. The ICAA's 2001 conference will be held in Carlsbad, California on April 19-20 and will feature a wide array of renowned speakers, including Warren Bennis (The Leadership Institute), Arthur Laffer (Laffer & Associates), Irwin Mark Jacobs (Qualcomm), Gerald Edelman (Neurosciences Institute), and a CEO panel of ICAA member firms.

- In May, the ICAA and *Investment Adviser Week* cosponsored a two-day compliance summit in Washington, D.C. Numerous officials from the SEC, along with ICAA staff, leading practitioners, and representatives of ICAA member firms provided the latest information at the conference on legal, regulatory, and compliance issues facing investment advisory firms. A similar conference will be held March 26-27, 2001 in Washington, D.C.

- In October, the ICAA again sponsored a conference designed exclusively for investment professionals. Entitled "*Portfolio Management Forum 2000*," the conference featured presentations from Dr. Jeremy J. Siegel (The Wharton School), J. Parker Hall III (Lincoln Capital Management Company), James Sarni (Payden & Rygel), Dr. Kevin Stephenson (Cambridge Associates), William Haines (FMS Group), Jeffrey Miller (Provident Investment Counsel), and Jon Henderson (Stein, Roe & Farnham), as well as case study from the Harvard School of Business Management. Preparations already have begun for a similar conference in 2001 and future years.

- In June, the ICAA convened a workshop for ICAA member firms in Boston where attorneys from the law firm of Bingham Dana discussed issues related to best execution.

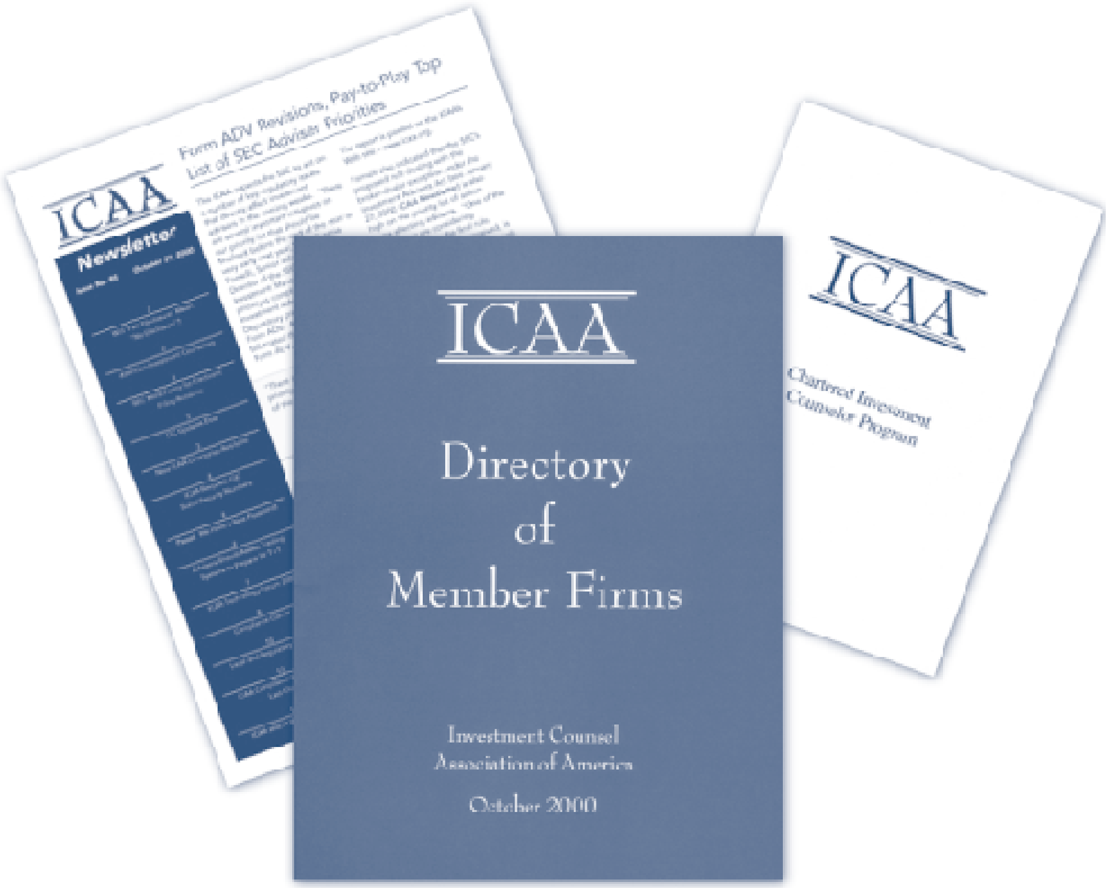
- The ICAA Board of Governors held quarterly meetings in February (Houston), June (Chicago), September (New York), and December (San Francisco) and hosted working luncheons for ICAA members in conjunction with each meeting. The ICAA's volunteer Board of Governors is continuing its efforts to increase benefits and services of the Association and to promote the ICAA and the investment advisory profession.

- In October and November, the ICAA convened compliance workshops for ICAA member firms – the fourth year in a row the Association has sponsored such meetings. More than 300 persons attended the workshops, which were held in Dallas, Chicago, Atlanta, San Francisco, Los Angeles, Washington, D.C., Boston, and New York. ICAA staff and attorneys from the law firms of Wilmer, Cutler & Pickering and Dechert combined to provide current information on Form ADV revisions and the Investment Adviser Registration Depository, the SEC's new privacy regulations, and other significant legal and regulatory developments.

- In November, the ICAA hosted a conference in San Francisco designed for ICAA operations and technology personnel. Entitled, "*Technology Forum 2000: Revolution/Evolution*," the two-day conference featured discussions regarding the role of the Internet, developments in portfolio accounting and management systems, privacy and security, T+1, trends in trading technologies, and managing technology, as well as presentations by William Hambrecht (WR Hambrecht + Co.), Frank Minard (InvestorForce), and Stephanie DiMarco (Advent Software).

- In December, the ICAA and *Investment Adviser Week* cosponsored a conference in Washington, D.C. to discuss the SEC's new regulations on Form ADV and the Investment Adviser Registration Depository. More than 150 persons attended the meeting, which featured discussions among SEC officials, ICAA staff, leading practitioners, and ICAA member firms.

Service



One of the missions of the Association is to provide "benefits, services, and products that add value to member firms in their course of doing business." Four years ago, the ICAA relocated its office to Washington, D.C. Since that time, the Association has increased its communication and effectiveness with major policy makers and other organizations. The ICAA has increased its paid staff, including hiring an in-house legal staff that is able to provide major services to the membership. The ICAA has increased its public exposure, thus enhancing its effectiveness. As the following brief summary indicates, the ICAA has continued to provide its membership with a variety of other benefits and services during the past year.

Service

The ICAA is the only association whose sole purpose is to serve the investment advisory profession.

- Since December 1996, we have published a monthly edition of the *ICAA Newsletter*. The newsletter is a major component of our efforts to keep the membership fully informed of all aspects of the ICAA's activities and of relevant industry trends and developments. Any employee of an ICAA member firm who wishes to be included on the newsletter mailing list should simply contact the ICAA office.

- During the past year, ICAA General Counsel Karen Barr and Counsel Dan Kahl have responded to hundreds of requests for information about regulatory and compliance issues from our members. These "retail" services are an important and unique aspect of the ICAA's services to its membership. In an effort to sustain and augment our ability to provide these valuable services, we are pleased to announce that Ms. Philippa Hughes will be joining the ICAA staff as Counsel in January 2001.

- Our Internet site, located at www.icaa.org, was launched in April 1997. Since then, we have added a variety of enhancements, including a "Members Only" area that features legal and regulatory updates (now searchable), past issues of the *ICAA Newsletter* (also searchable), and a message board that allows ICAA members to communicate with each other and with ICAA staff. The ICAA Web site contains links to ICAA member firm sites and other industry and informational sites, employment listings, and a searchable section that contains copies of significant comments and statements of the ICAA.

- Through a special arrangement, the ICAA offers Web site development services of its technology consultant, Mr. Kenneth Holley, at a reduced rate. During the past year, several ICAA members retained Mr. Holley to create Internet sites for their firms.

- In August, the ICAA provided to each member firm updates of our two-volume set of legal, regulatory and compliance materials, including information on the SEC's new privacy rules, updated Blue Sky charts, and materials relating to personal trading and other issues. Entitled *The ICAA Investment Adviser*, the compilation includes a variety of current and historical information on investment adviser issues and practices, from a revised specimen advisory agreement to memoranda dealing with soft dollars, ERISA, performance measurement and advertising, and many other areas that relate directly to investment management firms.

- The Chartered Investment Counselor (CIC) designation, sponsored by the ICAA, is designed to recognize individuals who have met significant education and experience qualifications in performing investment counseling and portfolio management functions. Last year, the North American Securities Administrators Association issued a model rule urging all state regulators to adopt regulations that waive investment adviser competency examination requirements for persons with certain professional designations, including CIC charter holders.

- In October, the ICAA published and distributed its *Directory of Member Firms and Directory of Firm Personnel*. ICAA membership currently stands at more than 275 firms, the highest level in our 63-year history. More than 35 firms, collectively managing in excess of $350 billion in assets, were approved for membership during 2000. Continuing to build our membership remains one of the highest priorities of the Association.

ICAA

Investment Counsel Association of America, Inc.
1050 17th Street, N.W., Suite 725
Washington, D.C. 20036-5503
202-293-ICAA
FAX: 202-293-4223
Internet: www.icaa.org