INVESTMENT ADVISER ASSOCIATION

2003 Comments & Statements

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ICAA

January 13, 2003

Via Electronic Mail and Courier
The Honorable Harvey L. Pitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

RE: Regulation Analyst Certification, Release Nos. 33-8119; 34-46301; File No. S7-30-02

Dear Chairman Pitt:

In anticipation of the Commission's open meeting scheduled for January 15, 2003 to consider adoption of Regulation Analyst Certification (Regulation AC), the Investment Counsel Association of America[1] strongly urges the Commission to adopt a final rule that applies only to *sell-side* research analysts. The scope of Regulation AC should be appropriately tailored to the scope of the abuses it is targeting – the influence of a firm's investment banking business on research recommendations made by its analysts.

On September 23, 2002, we submitted a comment letter that requested the Commission to explicitly exclude investment advisers from the scope of Regulation AC. We renew this request with heightened concern in light of the Commission's recent release of proposed NASD and NYSE analyst rules that would expand the definition of "research report" by eliminating the requirement that a research report include a *recommendation.*[2] The inclusion of a recommendation was a significant limiting factor with respect to investment advisers, who generally do not make investment recommendations to the general public.

As we explained in our September 23, 2002 letter, the proposed rule would apply to *any person associated with* a broker-dealer, potentially including affiliates, that

[1] The ICAA is a not-for-profit organization that exclusively represents the interests of federally registered investment adviser firms. Founded in 1937, the ICAA today consists of about 300 SEC-registered adviser firms that collectively manage in excess of $3 trillion in assets for a wide variety of institutional and individual clients. For additional information, please consult our web site: www.icaa.org.
[2] Self-Regulatory Organizations: Notice of Filing of Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344 ("Supervisory Analysts"), 345A ("Continuing Education for Registered Persons"), 351 ("Reporting Requirements") and 472 (Communications with the Public") and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest, Rel. No. 34-47110 (Dec. 31, 2002), 68 Fed. Reg. 4 at 826 (Jan. 7, 2003).

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circulates a research report prepared by a research analyst. The term research analyst is not limited to persons employed by or associated with a broker-dealer. Accordingly, Regulation AC may apply to independently run investment advisory firms that are affiliated with broker-dealers. As we discussed in our letter, there simply is no justification for this result:

> Buy-side analysts do not face the types of conflicts or engage in the types of practices that gave rise to this regulation. Further, no record of abuse has been demonstrated to justify inclusion of any segment of investment advisers. Buy-side firms generally do not have an investment banking relationship with the companies that they study or in which they invest. Buy-side analysts have no internal incentive to make statements that are contrary to the analysis they have performed.
>
> Buy-side analysts typically work for institutional money managers, including advisers to mutual funds and hedge funds. Investment advisers derive their revenues from fees paid by advisory clients based on a percentage of assets under management. They research companies as part of the investment decision-making process for their client portfolios on a discretionary basis. For buy-side analysts, success or failure is a direct function of the accuracy and value-added nature of their analysis. Buy-side analysts are successful if their investment decisions result in good performance for their clients' accounts, leading to growth in assets under management. Their interests are directly aligned with their clients' interests.[3]
>
> Further, investment advisers operate under a legal framework that requires advisers to mitigate or eliminate conflicts of interest or, in the alternative, to disclose them.[4] Investment advisers have a fiduciary duty to act solely in the best interests of their clients and to act with the utmost duty of faith and loyalty.[5] Broker-dealers do not have such an explicit fiduciary duty in relation to their customers. An adviser's affiliation with a broker-dealer does not relieve the adviser from its fiduciary obligations and therefore, application of Regulation AC to investment advisers affiliated with broker-dealers would not offer any additional investor protection.[6]

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[3] In requiring certification that analysts truly believe their own recommendations, the Commission may also intend to address potential conflicts raised by personal trading in the securities being recommended. In contrast to broker-dealers, most advisers have in place comprehensive codes of ethics that restrict personal securities transactions by managers and analysts in a manner designed to prevent conflicts of interest.

[4] *See Opening Statement by Chairman Arthur Levitt: Amendments to Form ADV* (April 5, 2000) ("Investment advisers have two choices under the [Advisers] Act. They must rid themselves of all conflicts of interest with their clients … Or, they must fully disclose any conflicts to clients and prospective clients").

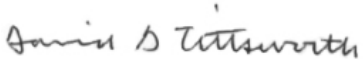
[5] *See, e.g., SEC v. Capital Gains Research Bureau,* 375 U.S. 180, at 186 (1963); *In re Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

[6] If the Commission in fact intends that some investment advisers will be covered by proposed Regulation AC, we believe the Commission should include an explanation of what situations it is intending to address and the basis for such inclusion.

A number of commenters recognized this problem and proposed solutions to the overly broad scope of proposed Regulation AC. The ICAA, ICI, and others proposed that the Commission explicitly exclude investment advisers from its scope. A group of independent research providers proposed that the rule apply only to broker-dealers with investment banking departments.[7] One law firm commenter suggested that the definitions of "research analyst and "research reports" specifically exclude investment advisers "acting within the scope of their duties."[8] Another law firm proposed that the definition of "research analyst" be limited to persons employed by or directly or indirectly receive compensation from, or share in the profits of, an SEC-registered broker-dealer.[9] Should the Commission decline to explicitly exclude investment advisers, we submit that, at a minimum, the Commission should limit the definition of "research analyst" to persons *employed and compensated* by a broker-dealer.

We welcome the opportunity to discuss this subject in greater detail with the Commission or its staff. Please do not hesitate to contact me if you have any questions about our views on these important issues.

Sincerely,



David G. Tittsworth
Executive Director

cc: The Honorable Richard Shelby
The Honorable Michael G. Oxley
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
Annette L. Nazareth
James A. Brigagliano
Paul F. Roye
Robert E. Plaze

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[7] Letter dated Sept. 20, 2002 from Investorside Research Association to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission. This would also serve the purpose of appropriately excluding limited purpose broker-dealers formed by the advisers for the sole purpose of distributing proprietary mutual funds.

[8] Letter dated Sept. 23, 2002 from Sullivan & Cromwell to Jonathan G. Katz, U.S. Securities and Exchange Commission.

[9] Letter dated Sept. 12, 2002 from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, U.S. Securities and Exchange Commission.

ICAA

January 16, 2003

Via Electronic Filing

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

Re: Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8150, 34-46868; File No. S7-45-02

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments related to the Commission's proposed rules under Section 307 of the Sarbanes-Oxley Act of 2002 (Section 307) that would establish standards of professional conduct for attorneys who, as part of their representation of issuers, appear and practice before the Commission.[2] We write in support of the arguments made by the Investment Company Institute (ICI) in its comment letter dated December 18, 2002 with respect to investment advisers to mutual funds.[3] In particular, we have serious concerns regarding the Commission's proposed position that an attorney representing an investment adviser to a mutual fund "jointly represents" the investment company. In addition, we join other commenters in urging the Commission to defer adoption of provisions that go beyond the statutory mandate of Section 307 until the Commission has a more reasonable opportunity to conduct a considered review of the comments.

<u>The Proposal should not apply to attorneys employed by or retained by an investment adviser that manages a mutual fund.</u>

Section 307 directs the Commission to adopt a rule imposing a reporting requirement on attorneys who appear or practice before the Commission "in the representation of issuers."

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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 approximately 300 investment advisory firms that collectively manage in excess of $3 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[2] *Implementation of Standards of Professional Conduct for Attorneys*, Release Nos. 33-8150; 34-46868; IC-25829; File No. S7-45-02 (November 21, 2002) ("Proposal").

[3] Letter from Craig S. Tyle, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (December 18, 2002) ("ICI letter").

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This includes any attorney who acts "on behalf of, at the behest of, or for the benefit of" any issuer. The Commission proposes to take the position that an attorney employed by an investment adviser who prepares or assists in preparing materials that will be filed with the Commission on behalf of an investment company is representing the investment company before the Commission. The Commission asserts that the attorney for the investment adviser has joint clients"- the so-called "Joint Representation Position."

We believe that the Commission's Joint Representation Position is misplaced and goes beyond the scope of regulation mandated by Section 307. An attorney employed or retained by an investment adviser to a fund should not be deemed to be jointly representing the fund.[4] Investment companies and investment advisory firms are two separate entities, each entitled to their own counsel. Attorneys for investment advisers are employees of the advisory firm and have professional responsibility duties to their own employer. The relationship between a mutual fund and its investment adviser is contractual. As part of the contract, the investment adviser may perform services that include preparation of certain documents to be filed with the Commission. However, this contract is between the investment advisory firm and the investment company - not between the investment company and the adviser's attorneys.[5] Indeed, in most instances, mutual funds have separate counsel. In addition, as part of a fund board's fiduciary duties to its shareholders, the board must be independent from the adviser and the independent directors of the board often retain their own independent counsel.

The Commission's proposed position would undermine the attorney-client privilege between an adviser and its attorneys. In addition, the position may result in increased legal expenses for funds, as advisory personnel may feel compelled to cease assisting in the preparation of fund filings.

Accordingly, we urge the Commission to eliminate its proposed position that attorneys employed by or retained by an investment adviser to a fund are deemed to be jointly representing the fund.[6]

We also support the ICI's position that attorneys that serve in a non-legal capacity at the fund adviser's firm should not be subject to the Proposal. These individuals are not members of the advisory firm's legal department and do not act in their capacities as lawyers. Therefore, they are not "practicing before the Commission" or "involved in the representation of an issuer." We agree that this would be "an unjustified expansion of the proposed rule's reporting obligations."[7]

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[4] Similarly, we do not believe that sub-advisers to a fund should be treated as jointly representing the fund. Typically, a subadviser to a fund has an independent contractual relationship with the fund's adviser to manage all or a portion of the fund's assets. The subadviser is not retained by the fund to serve as its attorney.

[5] An adviser's fiduciary duty to its client, the investment company, does not convert the adviser's attorneys into attorneys for the investment company.

[6] In this regard, we also support the comment letter submitted by the Committee on Investment Management Regulation of the Association of the Bar of the City of New York (Dec. 16, 2002).

[7] ICI letter at 5.

The Commission should defer adoption of the "noisy withdrawal" and "reporting out" requirements.

The Proposal would require an attorney appearing or practicing before the Commission who does not receive an appropriate response regarding a material violation to effect a so-called "noisy withdrawal" and to notify the Commission of the withdrawal. Many commenters have already raised concerns with the "reporting out" and "noisy withdrawal" requirements under the proposed rules, especially in light of its effect on the attorney-client privilege and possible conflicts with state law. We share some of these concerns and believe that these provisions require additional consideration and refinement.

We understand that the Commission is under a very short timeframe and must adopt "minimum standards of professional conduct" for attorneys by January 26 of this year. Accordingly, we join other commenters in urging the Commission to limit its rulemaking at this time to solely the *minimum* required rules under Section 307 by adopting an effective "up the ladder" reporting requirement *within* the issuer organization. We recommend that the Commission defer adoption of the more complex and difficult provisions (some of which are outlined in this letter) until such time as the Commission has additional opportunity to review and seek comment on them.

We appreciate the opportunity to comment on the proposed rules and would be pleased to discuss any questions the Commission or its staff may have with respect to the adviser-fund relationships raised by the Proposal.

Sincerely,

Karen L. Barr
General Counsel

cc: Harvey L. Pitt, Chairman
Cynthia A. Glassman, Commissioner
Roel C. Campos, Commissioner
Harvey J. Goldschmid, Commissioner
Paul S. Atkins, Commissioner

ICAA

February 10, 2003

Via Electronic Filing

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

Re: Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5
Release Nos. 33-8170, 34-47069, 35-27627, IC-25872; File No. S7-52-02

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments related to the Commission's proposed rules that would require electronic filing and website posting by issuers with corporate websites of beneficial ownership reports under Section 16(a) of the Securities Exchange Act (Section 16 Reports). ICAA members collectively manage trillions of dollars in assets for institutional and individual investors, and require adequate, prompt, and complete information from issuers to make appropriate investment decisions on behalf of their clients. The proposal, required by Section 403 of the Sarbanes-Oxley Act of 2002, would provide investment advisers and other investors with ready access to timely and important information about insider transactions. As investors, we strongly support the proposal and previous Commission initiatives to improve the transmission of clear and current information about companies to investors.[2]

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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 approximately 300 investment advisory firms that collectively manage in excess of $3 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[2] The ICAA has submitted numerous comment letters in support of other similar Commission initiatives to improve corporate disclosure. *See* Letter from Karen L. Barr, General Counsel, ICAA, to Jonathan G. Katz, Secretary, SEC dated July 24, 2002 (supporting the Commission's proposals to expand Management's Discussion and Analysis disclosure related to critical accounting estimates and policies); *see also* Letter from Karen L. Barr, General Counsel, ICAA, to Jonathan Katz, Secretary, SEC dated June 27, 2002 (supporting expanded and expedited disclosure in Item 10 to Form 8-K); *see also* Letter from Karen L. Barr, General Counsel, ICAA, to Jonathan G. Katz, Secretary, SEC dated August 26, 2002 (supporting additional Form 8-K disclosure requirements).

The proposal would mandate electronic filing of Form 3, the initial statement of beneficial ownership, Form 4, the statement of changes in beneficial ownership, and Form 5, an annual statement of beneficial ownership. An issuer's insiders use Forms 3, 4 and 5 to report beneficial ownership of and trading in equity securities of the issuer. Consistent with Sarbanes-Oxley, the proposal would require electronic filing of these Section 16 Reports. The proposal also would require all issuers with corporate websites to post these reports on their website by the end of the business day after filing. An issuer may choose to provide access to forms directly or through a hyperlink to a third-party service.

The Commission's proposal will provide for more prompt and efficient disclosure and access to information about insiders at public companies. Investment advisers regularly assess information regarding insider transactions in analyzing issuers. Many advisers believe that transactions by officers and directors in company securities provide insights into management's views about the company's current condition and future outlook. The posting of this information on company websites would facilitate even better access to this important information. Given the convenience to investors of using the Internet to access information and the relative cost to companies in posting such information, we believe that a company with an electronic presence should be required to post insider information on its website.

We have the following responses with respect to some of the Commission's specific requests for comment:

- Posting of Form 3. We believe that issuers that maintain corporate websites should post all Section 16 Reports, including Form 3. Web access to information on Form 3 is important to investors because it provides timely and complete disclosure regarding initial ownership positions, which is useful in assessing changes in equity holdings.
- Length of Website Posting. We recommend that, at a minimum, Section 16 Reports be posted for a period of 12 months. The Commission may also want to consider keeping these forms accessible for a longer period of time so that investors may have the opportunity to study trends in ownership positions and transaction history.
- Access to Section 16 Reports by Hyperlink. We agree that a company with a corporate website can satisfy the posting requirement either by providing access directly or by hyperlinking to the reports via a third-party service. Both approaches are acceptable provided the forms are easily accessible. Accordingly, the conditions set forth in Section II.B. of the proposal should make clear that a company that chooses to display the reports by hyperlink should display the link clearly on the its website and the link should allow the user direct access to the reports.

We appreciate the opportunity to comment on the proposed rules and would be pleased to discuss any questions the Commission may have with respect to this letter.

Sincerely,

Karen L. Barr
General Counsel

cc: Harvey L. Pitt, Chairman
Cynthia A. Glassman, Commissioner
Roel C. Campos, Commissioner
Harvey J. Goldschmid, Commissioner
Paul S. Atkins, Commissioner

ICAA

April 17, 2003

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549-0609

Re: File No. S7-03-03; Proposed Rule: Compliance Programs of Investment Companies and Investment Advisers

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments regarding the Commission's proposed rule that would require investment advisers to adopt written compliance policies and procedures.[2] Proposed Rule 206(4)-7 under the anti-fraud provisions of the Investment Advisers Act of 1940 would require advisers to adopt and implement written policies and procedures designed to prevent violations of the Advisers Act, conduct an annual review of such policies and procedures, and designate a chief compliance officer responsible for administering the policies and procedures. Proposed Rule 38a-1 under the Investment Company Act would impose similar requirements on investment companies, with the additional components of fund board approval of the compliance program and compliance officer reports to the board.

The ICAA consistently has promoted the use of written policies and procedures as an integral "best practice" component of an effective investment adviser compliance program. Our organization often has suggested that firms adopt written policies and procedures even though, as a matter of law, such policies and procedures are not specifically mandated. We believe written policies and procedures: (1) can assist an advisory firm in fulfilling its fiduciary responsibility to its clients; (2) help to create an environment within an advisory firm that promotes increased awareness of and compliance with applicable laws and regulations; and (3) reduce the potential liability of an advisory firm for violations of the securities laws.

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[1] The Investment Counsel Association of America, Inc. is a not-for-profit organization that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA's membership today consists of about 300 federally registered advisory firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. For more information about the Association, please see our web site at www.icaa.org.

[2] *Proposed Rule: Compliance Programs of Investment Companies and Investment Advisers*, SEC Release Nos. IC-25925, IA-2107; File No. S7-03-03 (February 5, 2003) ("Proposal").

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Accordingly, as a matter of best practices, we support the principles that an adviser should have written compliance policies and procedures appropriate to the nature of the firm and its business, designate personnel responsible for compliance, and conduct an annual review of its compliance program. However, we have serious reservations about the propriety of using an anti-fraud rule to mandate these practices. As set forth in more detail below, we are concerned that: (1) the Commission intends to articulate "minimum" topics for compliance policies and procedures that do not differ based on size or nature of each firm; (2) given the comprehensive nature of such minimum procedures and the anti-fraud rubric of the rule, the cost of compliance, particularly for small firms, will be significant; and (3) any deficiency alleged by examiners and enforcement staff related to policies and procedures could be characterized as a fraud.

We therefore strongly urge the Commission to consider taking a somewhat different approach by issuing an interpretive release under Section 203(e) of the Investment Advisers Act instead of adopting an anti-fraud rule.[3] Section 203(e) provides a defense in a failure to supervise action for persons who have established and implemented procedures reasonably designed to prevent and detect violations. We believe this approach will achieve our mutual goals of increased investor protection and adviser compliance but will reduce the possibility of the rule being used inappropriately.

The Commission has also requested comment on additional means to involve the private sector in enhancing compliance by advisers and funds with the federal securities laws. Specifically, the Commission proffers the following approaches: a self-regulatory organization (SRO) for funds and/or advisers; periodic third-party compliance reviews of each fund and adviser; expanded audits by fund accountants; and a fidelity bonding requirement for advisers.

The ICAA strongly opposes an SRO for investment advisers. We believe the current system of regulation has created an effective system of compliance and oversight and that radical change is not needed or appropriate. In addition, there is no compelling evidence that the other approaches proffered by the Commission would be effective at enhancing compliance, although we would not object to further study of these ideas.

I. Overview of the Investment Advisory Profession and the Advisers Act.

The investment adviser profession is a large and extremely diverse industry. On one end of the spectrum, a few large investment advisory firms manage the bulk of total client assets.[4] Many of these firms are affiliated with other investment advisers, banks, broker-dealers, and insurance companies. In fact, the 284 largest investment advisory

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[3] This would enable the Commission to gain experience and obtain more reliable data than is currently available. We note that the current proposal was developed very quickly and we believe the Commission could benefit from further study and better empirical data about the need for and costs of the proposed rule.

[4] *See, e.g.,* ICAA/NRS, *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* (September 2002) at 5-6 (258 investment advisory firms employ more than 250 persons, including 95 firms that employ more than 1,000 persons). The ICAA and NRS are in the process of updating this report for 2003. The relevant percentages reported in the 2002 report appear to be substantially similar to the preliminary 2003 data under study.

firms manage 82 percent of the $20 trillion in discretionary assets managed by all SEC-registered advisers.[5]

The vast majority of investment advisory firms, however, are quite small.[6] They tend to employ a few highly educated professionals who generally work together in intimate, collegial settings. SEC data reflect that almost 50 percent of all registered investment adviser firms have only one to five employees.[7] Indeed, more than 5,000 firms or 67.5 percent of all SEC-registered advisers have ten or fewer employees.[8] More than 6,000 firms, or about 82 percent, have ten or fewer employees performing investment advisory functions.[9] We believe the SEC should continue to foster an environment that is conducive to supporting the robust and dynamic population of relatively small businesses that dominate the U.S. investment advisory profession.

The law governing the activities of investment advisers, the Investment Advisers Act of 1940,[10] is relatively simple, straightforward, and effective. Certain investment advisers are required to register with the SEC and are subject to regulations issued and enforced by the Commission.[11] The statute makes it unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client or prospective client" or to engage in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[12] 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."[13] Consistent with the other major federal securities laws, the Advisers Act largely relies on full and fair disclosure to effect its purposes.

Of particular note, all investment advisers are subject to a strict fiduciary duty that is intended to eliminate or require disclosure of conflicts of interest and to prevent an adviser from overreaching or taking unfair advantage of a client's trust.[14] As a fiduciary, the adviser must act in the best interests of the client and must disclose material information. The fiduciary duty serves as a primary line of defense in protecting clients from adviser misconduct. Among obligations that flow from an adviser's fiduciary duty are: (1) the duty to have an adequate, reasonable basis for its investment advice; (2) the duty to seek best execution for clients' securities transactions where the adviser directs such transactions; (3) the duty to render advice that is suitable to clients' needs,

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[5] *Id.* at 3-4.
[6] More than 83% of SEC-registered advisory firms manage less than $1 billion in assets. *Id.* at 3.
[7] *Id.* at 5-6. There are more than 7,500 SEC-registered investment advisers and perhaps as many as 15,000 state-registered investment advisers. *Id.* at 2. The percentage of small firms among state-registered advisers obviously would be substantially higher than among SEC-registered investment advisers. This is relevant because states tend to incorporate SEC rules into their own regulations.
[8] *Id.* at 5-6.
[9] *Id.*
[10] Investment Advisers Act of 1940, 15 U.S.C. 80b-1 *et seq.*
[11] *See* Sections 203 and 209, Investment Advisers Act of 1940.
[12] Section 206(1), (2), and (3), Investment Advisers Act of 1940.
[13] Section 206(4), Investment Advisers Act of 1940.
[14] See, *e.g.*, §206, Investment Advisers Act of 1940; *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

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.[15]

Thus, while the legal framework governing investment advisers is relatively uncomplicated, an adviser's legal obligations are rigorous. Disclosures required of advisers in registering with the SEC alone are without precedent in other regulated professions. Each adviser is required to disclose its 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, proxy voting policies and procedures, and numerous other matters that describe activities that may pose potential conflicts of interest with the adviser's clients, including specific disclosures relating to trading and brokerage practices. Also unprecedented is the amount of information regarding each registered adviser - including any disciplinary history - that is available to the public on the Internet via the Commission's Investment Adviser Public Disclosure web site.[16]

Although currently the Advisers Act does not expressly require an investment adviser to have written policies and procedures in many areas, a number of factors have compelled many advisers to implement such a practice.[17] First, an investment adviser has a duty to supervise any person acting on its behalf.[18] Under existing law, without reasonably designed policies and procedures, an investment adviser would not be able to avail itself of one of its most effective defense against a failure to supervise action. Second, SEC staff have consistently and clearly commented on the importance of establishing internal controls and have emphasized that written policies and procedures are important elements of a good compliance program.[19] Third, good compliance controls are an integral part of a risk management program, which is suggested by sound business practices and demanded by many clients. Given these regulatory and business considerations, investment advisers are highly motivated to create a compliance environment with adequate internal controls and supervisory procedures that protect their clients and their firms.

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[15] *See* Anderson, Bagnall & Smythe, *Investment Advisers: Law & Compliance,* Section 9.02-04 (2003); Lemke & Lins, *Regulation of Investment Advisers,* at 2-38 (2001 edition).
[16] *See* www.adviserinfo.sec.gov.
[17] §204A of the Investment Advisers Act of 1940 requires all advisers to have written insider trading policies. In addition, Rule 17j-1 of the Investment Company Act of 1940 requires advisers to mutual funds to adopt a code of ethics governing personal trading; Regulation S-P, 17 C.F.R. Part 248 requires advisers to natural persons to adopt privacy policies; and Rule 206(4)-6 under the Investment Advisers Act of 1940 requires advisers that vote proxies on behalf of clients to adopt proxy voting policies and procedures.
[18] §203(e)(6), Investment Advisers Act of 1940.
[19] *Open letter from Lori A. Richards*, Director, SEC Office of Compliance, Inspections and Examinations (May 1, 2000).

II. Specific Comments on the Proposed Rule Requiring Compliance Programs.

A. Adoption and implementation of written policies and procedures.

The ICAA generally supports the concept of requiring advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the adviser and its supervised persons. We have consistently encouraged investment advisers to establish adequate and appropriate policies and procedures. Indeed, we believe that many firms, particularly larger firms, already have written policies and procedures covering many aspects of their operations. We applaud the Commission for providing substantial flexibility in its proposed rule to enable advisers to "take into consideration the nature of each organization's operations."[20] However, we have four general concerns regarding this aspect of the proposal.

First, given the diversity of advisory firms, the ICAA submits that minimum requirements for compliance programs are not appropriate, either as part of a rule or even as articulated in any adopting release. Second, we have serious concerns regarding the cost of establishing and implementing comprehensive written policies and procedures, particularly for small investment advisory firms. These costs could be substantial relative to firm size and resources. Third, the proposal seemingly reflects the Commission's increasing inclination to find that whenever a violation of securities law has occurred, there must have been either a breach of an adviser's policy or procedure or, alternatively, the policies and procedures themselves have been deficient. The proposal, if used aggressively, could turn every adviser deficiency into an enforcement action based on fraud. Finally, with respect to the parallel fund proposal, we recommend that the Commission not require board approval of policies and procedures of independent sub-advisers to mutual funds.

1. Minimum policies and procedures required.

The Commission requests comment on whether the rule or adopting release should specify certain minimum policies and procedures that must be established and implemented. We strongly submit that neither the rule nor the release should specify the minimum areas to be addressed by policies and procedures. To be effective, compliance policies and procedures and the business practices necessary to establish a compliance culture within an advisory firm must be specific to the firm. The firm itself is in the best position to determine the appropriate scope of its formal written procedures.

The proposing release sets forth a lengthy list of areas that policies and procedures of funds and advisers should "at a minimum" address.[21] We surveyed a sample of ICAA members of various sizes that approximately mirror the SEC-registered universe of advisers. Although all of these advisers had written policies and procedures addressing at least one area, most of the advisers surveyed did not have written policies

[20] Proposal at 5.
[21] Proposal at 6.

and procedures covering every item on the SEC's proposed "minimum" list - and with good reason. A three-person firm that does not have actual custody of client assets probably does not need a written policy for "safeguarding of client assets from conversion or inappropriate use by advisory personnel." A small firm with a limited number of clients probably does not need *written* policies and procedures to test consistency of portfolios with guidelines. Most firms do not need a written policy to remind them to review and file Form ADV annually; they just do it. A sole proprietor may not need to write down his contingency plan that his backup systems are at his house. Some of the proposed minimum policies would be unnecessary and would add cost with no commensurate benefit.

Accordingly, although it may be useful to provide a suggested list of the *types* of policies and procedures that a firm could consider adopting, we do not believe that it is necessary or advisable to specify *minimum* requirements beyond those already required under existing law. Firms vary vastly by size and type; their need for written policies and procedures will necessarily vary. The Commission should allow enough flexibility for each firm to adopt only those procedures that make sense for that firm and its clients.

2. Cost considerations.

The Commission notes that the proposal would impose "larger relative costs" on small firms.[22] We share this concern. It is very difficult to quantify the cost of writing policies and procedures for such firms because they do not typically employ a full-time compliance official whose time can be easily allocated to this task. The SEC estimates that implementing this rule would require an average of 80 internal hours for each firm. However, the cost of this time is not clear. In its proxy voting rule proposal, the SEC estimated that a compliance officer's time would cost $60 per hour.[23] In a small firm of fewer than five or ten employees, a portfolio manager or even the president of the company might be the compliance officer and the cost of his or her time would probably be much greater than $60 per hour.

Some advisers might consider hiring a third party to write their policies and procedures. The ICAA surveyed several service providers and law firms to determine how much it would cost to prepare compliance policies and procedures for investment adviser firms. The law firms in aggregate reported that writing policies and procedures could involve between 35 and 300 hours and that this amount of time would cost between $10,000 and $120,000, depending on the adviser's size and complexity. Similarly, larger accounting firms that offer consulting services developing customized policies and procedures estimate the cost at $50,000-60,000 for a mid-size advisory firm and at more than $200,000 for large global conglomerates.

We also surveyed several third-party service providers (non-law firm/non-accounting firm) that offer the service of assisting advisers in writing individualized policies and procedures. We found that these firms charge in the range of $2,500 to

[22] Proposal at 13.
[23] *Proposed Rule: Proxy Voting by Investment Advisers*, SEC Release No. IA-2059 (September 20, 2002).

$3,500 for a small to medium-sized firm. These amounts, though not astronomical, would still represent a significant cost to a small adviser, particularly given that they are only initial costs. They do not include the cost of periodic or annual updating or the cost of actual implementation on a daily basis.

We recognize that firms could purchase an off-the-shelf compliance manual from a third-party provider for under $1,000 as a starting point. However, the adviser would still have to spend a significant amount of time tailoring the manual to its own specific practices and procedures. Further, there are risks in providing an incentive for investment advisers to purchase such manuals because they might fail to tailor them sufficiently to meet the needs of their firm. Obviously, the quality of policies and procedures may vary significantly depending on whether firms use a law firm, an accounting firm, or other consultant experienced with investment adviser regulation to develop them, or simply spend a few hours modifying a purchased template. The implementation cost would have a significant economic impact on a small firm and we question whether the benefit warrants the cost.

3. Violation of the rule should not result in charges of fraud.

Because the Commission has proposed Rule 206(4)-7 under its anti-fraud authority, the failure of an adviser to maintain compliance policies and procedures, to review these policies and procedures annually, or to designate a chief compliance officer could constitute an "act, practice, or course of business which is fraudulent, deceptive, or manipulative" within the meaning of the anti-fraud rule.[24] Therefore, an adviser could be found to have violated the fraud section of the Advisers Act for the mere failure to have in place certain policies and procedures that the Commission deemed inadequate without having committed any substantive violation of the Act.

We believe that good compliance is essentially part of the supervisory obligation that is already imposed by law on advisory firms. It seems unfair to mischaracterize a policy drafting decision or breakdown in proper supervision as a fraud. For example, suppose an adviser erroneously charged a client a performance-based fee in violation of Section 205 of the Advisers Act. Also suppose that the proposed rules were adopted and the advisory firm failed to include what the Commission deemed to be an adequate discussion of the rules governing performance-based fees in its compliance manual. It seems fundamentally unfair to charge the firm with a violation of Section 205 for erroneously charging the fee and to add a potentially much more serious fraud charge based on the defect in the compliance manual.[25] We suggest that the defect in the compliance manual is better characterized as a defect in supervision, not as a fraud.

In addition, characterizing policy and procedure inadequacies as a fraud may have serious insurance implications. Typical errors and omissions policy forms for advisers include an exclusion for fraud by the insured or its officers or directors. Insurers may

[24] §206(4), Investment Advisers Act of 1940.
[25] This is particularly unfair because the new "fraud" violations would be part of the adviser's Form ADV disclosure. Such disclosure could mislead clients with respect to the gravity of the offense.

attempt to defeat coverage where there is an allegation or finding of deficient policies and procedures under an anti-fraud rule. Indeed, under the wording of some policies, insurers may even attempt to refuse to defend the action, much less cover any judgment against the adviser. Such a result would not benefit investors.

In addition, we have concerns regarding the Commission's ability to implement proposed rule 206(4)-7 in a flexible manner. Compliance policies and procedures are not scalable; the policies, procedures, monitoring, testing, and exception reporting that may be appropriate for large firms do not scale down to a small firm that has few barriers to inter-office communication. The list of potential topics that may be appropriate for written policies and procedures is growing and dynamic. Decisions regarding whether such policies and procedures should apply to any particular firm and its employees and how any such policies and procedures may be drafted involve numerous, complex, and even subjective considerations. Should this proposed rule be adopted, we strongly encourage specific training of the SEC inspection staff regarding the need to focus on overall process rather than specific check-the-box requirements, and to recognize permissible variations in compliance programs depending on the size, nature, and characteristics of firms and their clientele.[26]

Current statistics cited by officials from the Office of Compliance, Inspections, and Examinations (OCIE) indicate that virtually all (94 percent) investment adviser inspections result in deficiency letters.[27] In addition, according to OCIE, about half of all adviser deficiencies involve either: (1) inadequate written compliance policies or procedures, or (2) failure to follow written policies and procedures. We do not believe the rule will be beneficial to either advisers or their clients if it simply is used as the legal basis for "writing up" an additional problem in every deficiency letter or to ease the burden of bringing an enforcement action against an investment adviser. We urge the Commission to avoid allowing the rule, if adopted, to become a weapon that inspection and enforcement staff can use to second-guess and punish any investment adviser, rather than a useful tool that encourages advisers to design and implement effective compliance programs for the benefit of investors.

4. The role of subadvisers.

Although we are not commenting on the proposed investment company rule *per se*, we take this opportunity to express concern regarding the application of that proposed rule to independent subadvisers to investment companies, particularly for those advisers that act on behalf of more than one fund complex. It would be logistically difficult for subadvisers to submit their policies and procedures to various boards of the various funds they subadvise and incorporate comments received from different boards. In fact, this requirement could easily place the adviser in the difficult, if not impossible, situation of trying to negotiate a policy between one or more boards having different demands. We

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[26] We would be pleased to provide any assistance to the Commission or its staff in this regard.

[27] John H. Walsh, Chief Counsel, SEC Office of Compliance, Inspections, and Examinations, ICAA/*IA Week* Fourth Annual Compliance Summit (April 8, 2002); *see also* SEC 2002 Annual Report (reporting that 90% of investment adviser examinations resulted in deficiency findings during fiscal 2002).

submit that subadvisers should not be required to maintain separate firm policies and procedures for each fund advised, nor should they be required to only put policies in place that satisfy a single constituency. Subadvisers provide an important service to mutual funds but must retain flexibility to develop procedures appropriate for all of their clients. Accordingly, we request that the Commission clarify that fund boards are not required to approve the policies and procedures of independent, unaffiliated subadvisers.

B. Annual review of policies and procedures.

The Commission proposes that advisers review their policies and procedures annually. Such an annual review can be a useful compliance tool. As a practical matter, most firms already review their policies and procedures at the time they update Form ADV each year to ensure that their prior year disclosures are still consistent with their current practices, policies, and procedures. During this process, firms often reconsider their compliance policies and internal controls as a matter of course to evaluate whether they work as designed and whether changes are necessary to assure their continued effectiveness.

The Commission seeks comment on whether the proposed rule should require more frequent review of the policies and procedures than annually, such as quarterly. The ICAA opposes any formal requirement for firms to review their policies and procedures more frequently than annually. As the Commission issues interpretations of existing requirements and new directives throughout the year, firms typically reassess their policies and procedures to ensure compliance as needed. In addition, many firms' specific policies and procedures inherently require a periodic review. For example, a firm's best execution policy and procedures typically would require a periodic review. A firm's personal trading policies and procedures are continually monitored as employees engage in personal trading throughout the year. Further, because their operations can be quite complex, large firms already review their policies and procedures on a continuing basis to keep pace with internal changes. An annual review would serve as a useful check on these systems to ensure that steps have been taken during the year toward full compliance. A formal quarterly review, however, would add extra cost without adding any meaningful benefit to clients or advisers.

C. Designating a chief compliance officer.

The proposal would require every adviser to designate a chief compliance officer responsible for administering its compliance policies and procedures. We generally support such a requirement, given the Commission's assurance that this designation would *not* confer a duty on the designee to supervise another person.[28] The ICAA member firms we surveyed have one or more employees assigned to be responsible for compliance matters, and many of those firms have taken the additional step of designating a chief compliance officer. Thus, we believe the proposed rule would formalize a step that many firms have already taken. Nevertheless, we suggest that the adopting release emphasize a wide range of flexible approaches that may be appropriate

[28] Proposal at n.38.

when designating a chief compliance officer. For example, we appreciate the Commission's recognition that a small firm will likely not have anyone dedicated solely to compliance.[29] The Commission should also realistically recognize that for sole proprietors and other very small firms, the chief compliance officer designation may not result in significantly strengthened compliance oversight.

The Commission requests comment on whether the chief compliance officer should be required to certify the firm's compliance with its policies and procedures. We strongly oppose such a certification because it places an unfair burden on a single person to be responsible for an entire firm's compliance matters. Most compliance professionals would be reluctant to sign such a certification when 94 percent of SEC inspections result in a deficiency letter. Faced with such a high probability of being cited for a deficiency, few advisory firm employees would risk liability for filing what in hindsight could be deemed a misleading statement of compliance. Similarly, it is unclear as to what the compliance officer would certify. At a recent conference, SEC staff reportedly stated that "every firm has problems and should have examples of problems they have caught and fixed" and firms "that claim not to have had any problems they have caught and resolved could end up being visited once every two years and face exams that last about four weeks, instead of two weeks…."[30] Thus, any certification requirement could be a trap for the unwary compliance officer. Indeed, such a requirement could result in an unintended incentive for compliance officers to make procedures *less* specific and *less* rigorous in order to provide more comfort in certifying to their implementation.

The Commission also seeks comment on whether multiple persons can act as compliance officers. The ICAA supports allowing firms the flexibility to appoint multiple persons to share the role of chief compliance officer, particularly in a large or global firm. Having multiple compliance officers ensures that those with expertise in a particular area of compliance are responsible for monitoring compliance in that area.

The Commission further requests comment on whether it should require the chief compliance officer to be a member of senior management. It is critical that a chief compliance officer have sufficient authority to implement a firm's compliance program effectively. Moreover, a firm's compliance function will likely cross many departments in a large firm. Therefore, we strongly support a requirement that the chief compliance officer *either* be a member of senior management or *report directly to senior management*, to ensure that he or she can effectively oversee the firm's entire compliance program.

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[29] *See* Proposal at 14 ("the Proposed Rules would not require firms to hire an individual exclusively charged with serving in this capacity").

[30] *IAs Claiming Flawless Compliance Face More SEC Scrutiny*, Compliance Reporter (March 10, 2003) at 11 (reporting on SEC Speaks conference).

III. The ICAA Proposes An Alternative Approach to Proposed Rule 206(4)-7.

The ICAA respectfully submits that its concerns can be addressed, and at the same time good compliance efforts can be encouraged, if the SEC follows a slightly different approach in its rulemaking. Rather than adopting blanket requirements as anti-fraud rules, the SEC could issue an interpretive or concept release stating that the proposed compliance program should be treated as evidence of a firm's efforts to meet its current statutory obligation to properly supervise its employees. When a system of supervision is found to be defective, the violation would be cast more appropriately as a breakdown of supervision, not as a separate fraud.

Section 203(e)(6) of the Advisers Act states:

[N]o person shall be deemed to have failed reasonably to supervise any person if-

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

This provision provides a "statutory affirmative defense to a failure to supervise charge for investment advisers that demonstrate that they have established and complied with procedures reasonably designed to prevent and detect the violations at issue."[31] If the adviser has no policies or procedures appropriate to prevent and detect a particular type of unlawful practice that occurs, the adviser will not be able to avail itself of the Section 203(e) affirmative defense and will leave itself more exposed to a failure to supervise charge. Accordingly, the concept of good compliance policies and procedures is more suitably addressed as an interpretation of this provision than as a fraud in and of itself.

The issuance by the SEC of an interpretive or concept release would also have another value. It would permit the SEC more generally to clarify the standards of proper supervision at advisory firms, a subject that is unclear today. We urge the Commission to provide notice and seek public comment before issuing such a release.[32]

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[31] *In the Matter of Western Asset Management Co., and Legg Mason Fund Adviser, Inc.* Release No. IA-1980 (Sept. 28, 2001).

[32] Another alternative to the anti-fraud rule approach would be to promulgate a rule solely pursuant to Section 211(a) of the Advisers Act, which is cited by the Commission in n. 105 of the proposal as a separate basis of authority for the proposed rule.

IV. Request for Comment on Further Private Sector Involvement.

Expressing concern about whether its resources will keep pace with growth in the advisory industry, the Commission seeks comment on various approaches to involve the private sector in enhancing compliance with the federal securities laws. The Commission is considering: (1) requiring periodic third-party compliance reviews of each fund and adviser; (2) requiring expanded audits of funds by fund accountants; (3) a fidelity bonding requirement for investment advisers; and (4) establishment of a self-regulatory organization (SRO) for investment companies and/or investment advisers. While we understand the Commission's concerns regarding its resources, we submit that, at a minimum, further study is necessary before the first three of these approaches are seriously considered. In addition, we urge that the SRO approach be eliminated from consideration entirely.

A. Three of the Commission's private sector concepts require further study.

There is no compelling evidence that requiring third-party reviews, expanded audits, or fidelity bonds will be effective in enhancing investor protection or that the benefits would exceed the costs. Fidelity bonding is already required under ERISA and the Investment Company Act.[33] It is fairly widely used throughout the advisory industry.[34] However, there is little, if any, evidence that bonding enhances compliance programs or even protects the investing public from loss. We understand that in cases of serious misconduct, the insurer may contest coverage on a variety of grounds. This leaves the insured immersed in lengthy and costly litigation when the public would most need the protection of the bond. The ICAA is not necessarily opposed to this proposal, particularly for advisers with physical custody of client assets,[35] but does not believe its effectiveness has been demonstrated. An ineffective requirement may harm investor protection by providing a false sense of security.

We have serious concerns with respect to expanded audits and third-party compliance reviews as well. While some advisers have retained third parties to conduct compliance reviews, transforming this business decision into a rigid requirement is inappropriate and would impose substantial mandatory costs on advisers. Compliance reviews or "mock audits" by non-accounting consultants can cost in the range of $5,000 to $25,000 - or higher for large firms, while such audits by accounting-related consulting firms can cost from $30,000 to $100,000 or more *per audit.* There is no evidence that the level of expertise of every third-party consultant exceeds the expertise of in-house

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[33] We understand from insurance brokers, however, that investment advisers will not be able to simply add the type of fidelity bonding contemplated by the Commission to their existing ERISA bonds, but will have to purchase a separate bond.

[34] Approximately 57 percent of our survey respondents reported maintaining some type of fidelity bonding. The annual costs ranged widely from $1,200 to well over $100,000 principally depending on size of firm, amount of coverage, and deductibles.

[35] Indeed, fidelity bonds are intended to address custody and theft issues. We understand both from insurance brokers and our members that insurance company due diligence with respect to fidelity bonds focuses principally on custody-related issues.

personnel with knowledge of the firm's operations. Further, the SEC is currently in the midst of a sweeping overhaul of the accounting profession to improve its effectiveness. Until that effort is more advanced, and evidence is gathered regarding the marginal utility of expanded audits and third-party review, these proposals will impose needless costs on the industry without corresponding benefits to the investing public and could help to create an illusion of false security.

Accordingly, we submit the Commission should not consider these proposals until evidence is collected to evaluate their effectiveness. Given the absence of a compliance crisis in the industry - and recent enhancements to the Commission's budget and inspections program - a period of informed study appears both prudent and helpful. One possible method to conduct such a study would be for the SEC to require third-party reviews and expanded audits as part of settlements of enforcement actions. Although these proposals have been included in some settlements of SEC actions, the ICAA is unaware of any effort to study the effectiveness of the practices. The SEC could require follow-up reporting, in addition to the new procedures, as part of its settlements so that the evidence could be assembled to assess the effectiveness of these proposals. With respect to fidelity bonds, the SEC could gather and analyze information from the Department of Labor or the states that require such bonding.[36]

B. The ICAA Strongly Opposes a Self-Regulatory Organization for Investment Advisers.

The ICAA strongly opposes the establishment of a self-regulatory organization for the advisory industry. As discussed above, the investment management industry has a good record of compliance, free from systemic abuse or scandal. The SEC has been remarkably effective in its direct regulation of the industry, particularly since the passage of NSMIA.[37] In addition, the investment adviser industry is too diverse and fragmented to benefit from the self-regulatory model. Finally, a self-regulatory organization would be enormously expensive and difficult to create and would require congressional action. The Commission has not demonstrated that this dramatic step is necessary or warranted. To the extent that additional resources are needed by the SEC to oversee the industry, the ICAA strongly supports efforts to obtain those resources so that the SEC can continue its sixty-year role as the direct regulator of the advisory industry.

1. The SEC is an effective direct regulator of advisers.

The current system of direct regulation of investment advisers by the SEC has worked remarkably well. The advisory profession has not experienced the scandals and systemic problems that other industries have faced. To our knowledge, the only major regulatory problem identified during the sixty-plus year history of the Advisers Act was the ability of the Commission to conduct appropriate oversight of the advisory profession in the early to mid-1990s. We strongly believe that enactment of the Investment

[36] For example, the Commission could study claims data and insurer payout. Our members suggest that claims are seldom filed on fidelity bonds.
[37] National Securities Markets Improvement Act, Public Law No. 104-290 (1996).

Advisers Supervision Coordination Act in 1996 (Coordination Act)[38] solved this problem and, in fact, has resulted in a virtual revolution in adviser regulation accompanied by a prolific increase in inspection and enforcement activities by the Commission.

The Coordination Act divided regulatory responsibility between the Commission and the states by prohibiting an investment adviser from registering with the SEC unless it has more than $25 million in assets under management,[39] is an adviser to a registered investment company, or fits one of the limited exemptions. One of the Act's principal purposes was to leverage state and federal resources by "eliminating overlapping regulatory responsibilities."[40] This 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.[41]

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.

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 fewer than 8,000 advisers registered with the SEC.[42] Obviously, this means that the SEC has been able to concentrate its resources on a much smaller universe of advisers.

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

[39] 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. 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.

[40] S.Rpt.104-293, pp. 3-4 (June 26, 1996).

[41] *SEC Proposed Rules Implementing Amendments to the Investment Advisers Act of 1940,* Release No. IA-1601, File No. S7-31-96 (December 20, 1996).

[42] *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); Proposal at 3.

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, which subsequently became the Office of Investment Adviser Regulation (OIAR). During the last six years, the OIAR has taken the lead on a substantial number of rules and initiatives adopted or proposed by the Commission, including:

- various regulations implementing the Coordination Act;[43]
- new rules governing performance fees;[44]
- rules requiring the filing of Year 2000 readiness reports by advisers;[45]
- a proposed rule regarding the broker-dealer exception under the Advisers Act;[46]
- rules requiring privacy notices and policies;[47]
- rules overhauling Form ADV, Part 1 and establishing an electronic filing system for investment advisers;[48]
- proposed rules dramatically overhauling Form ADV, Part 2;[49]
- a new rule requiring proxy voting policies and procedures;[50]
- a proposed rule to revise the investment adviser custody rule;[51]
- an exemption from the prohibition on Commission registration for certain advisers operating through the Internet;[52]

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[43] *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).
[44] *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).
[45] *Investment Adviser Year 2000 Reports,* Release No. IA-1769, File No. S7-20-98 (October 1, 1998).
[46] *Certain Broker-Dealers Deemed Not To Be Investment Advisers,* Release Nos. 34-42099; IA-1845; File No. S7-25-99 (November 4, 1999).
[47] *Privacy of Consumer Financial Information (Regulation S-P),* Release Nos. 34-42974, IC-24543, IA-1883; File No. S7-6-00 (June 22, 2000).
[48] *Electronic Filing by Investment Advisers, Amendments to Form ADV,* Release No. IA-1897 (Sept. 12, 2000).
[49] *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV,* Release No. IA-1862; 34-42620; File No. S7-10-00 (April 5, 2000).
[50] *Proxy Voting by Investment Advisers*, Release IA-2106 (January 31, 2003).
[51] *Custody of Funds or Securities of Clients by Investment Advisers,* Release IA-2044 (July 18, 2002).
[52] *Exemption for Certain Investment Advisers Operating Through the Internet*, Release No. IA-2091 (Dec. 12, 2002).

- rules governing electronic record-keeping by investment advisers and investment companies;[53] and

- the launch of the Investment Adviser Public Disclosure web site, which provides the investing public access to background, business, and disciplinary information of registered investment advisers.[54]

Additional rules that are likely to be considered include exemptions from restrictions on principal trading under the Advisers Act, as well as rules relating to advertising and performance reporting, books and records, and anti-money laundering.

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 Office of Compliance Inspections and Examinations (OCIE) inspects every registered investment adviser at least once every 5 years. 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 soft dollar sweep of 280 investment advisers, a follow-up sweep on best execution practices, a sweep of advisers on performance issues, visits in 1998 to nearly 60% of advisers nationwide regarding Year 2000 readiness, a fact-finding review of advisers that manage hedge funds, and targeted inspections this past summer focusing on proxy voting.

Indeed, the director of OCIE has announced a new inspection plan for investment advisers that would reduce the inspection cycle further to no more than four years, with a two-year cycle for the largest firms that manage the majority of the aggregate assets under management by the industry.[55] She also announced a new method of inspection that would evaluate each adviser's risk management and internal control processes.[56] Those firms with weak internal controls will undergo a more rigorous and lengthy examination by OCIE staff.

Thus, the record is indisputable that investment advisers are subject to an increasingly complex regulatory environment and are subject to rigorous oversight by the Commission. Direct regulation is working well. There is no demonstrable need for a different regulatory structure.

In the past, a self-regulatory organization for advisory firms has been proposed as a means of committing greater resources to the regulation of that industry, particularly

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[53] *Electronic Recordkeeping by Investment Companies and Investment Advisers*, Release No. IA-1945 (May 24, 2001).
[54] *See SEC, State Regulators Launch Investment Adviser Information Website*, SEC Press Release 2001-99 (Sept. 25, 2001).
[55] Speech by Lori A. Richards, The Evolution of the SEC's Inspection Program for Advisers and Funds (Oct. 30, 2002) (available at: http://www.sec.gov/news/speech/spch597.htm).
[56] *Id.*

when SEC resources were viewed as inadequate and additional Congressional funding for the SEC was not forthcoming. Every time this crisis has been identified, SEC resources have increased, the burden on the SEC has been reduced (such as through the adoption of the Coordination Act), and a period of effective SEC oversight has followed. Today, the SEC has just received a significant budget increase and is in the midst of hiring new examiners and enforcement lawyers to oversee the industry. It is also in the midst of a review to determine whether it can use its existing resources more effectively. The ICAA supported this budget increase for the SEC and will support future increases if needed. Until the current budget increase is spent, and the current review of SEC operations is completed, there is simply no evidence that the SEC cannot properly oversee the advisory industry with its current resources.

2. The investment management industry is too diverse to benefit from the self-regulatory model.

The investment advisory profession is both diverse and fragmented. The 7,790 advisers registered with the SEC include: small advisers who provide investment counseling and/or financial planning services to individuals, small businesses, and local charitable and educational funds; advisers providing traditional investment counseling and money management services to high net worth individuals, endowments, businesses, and pension funds; advisers that focus principally on managing mutual funds that they have established; advisers that focus on sub-advising funds set up by others; firms that have a large "wrap" or "separately managed account" business involving agreements with numerous program sponsors; advisers focusing on hedge funds; small to medium sized advisers that offer boutique investment styles or strategies; and firms with thousands of employees and offices in various countries that offer a variety of institutional and retail financial products and services (including hedge funds, mutual funds, separately managed accounts, institutional money management, brokerage, and banking) to a diverse group of clients.

Some advisers are completely independent – not owned by or affiliated with any other entity. Others are owned by or affiliated with banks, broker-dealers, insurance companies, holding companies, and other investment advisers. Some SEC-registered advisers are registered through an exemption and do not even directly manage assets, such as nationally recognized statistical rating organizations (NRSROs), pension consultants, and multi-state advisers. There are obvious differences between how such firms conduct their business. Command-and-control requirements of the sort established by SROs do not lend themselves to the widely divergent community of advisers. Indeed, the high level of interconnectivity between broker-dealers and the commonality of technical issues related to settlement, execution, and reconciliation involving broker-dealer transactions that persuaded Congress to authorize the creation of an SRO for broker-dealers simply do not exist in the investment advisory profession.

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

appropriate and effective for the investment adviser profession. No additional layer of regulation is required.

3. An SRO would be extremely expensive and difficult to create.

Creating a self-regulatory organization from a blank slate can be exceedingly difficult and expensive.[57] The SEC need only reflect on its current efforts in that regard with respect to the accounting profession to appreciate how difficult and expensive this task can be.[58] Even more difficult than creating an SRO can be maintaining the effectiveness of that SRO. In recent years, the SEC has taken action against both the NASD and the New York Stock Exchange, two well-established SROs, for failing to enforce their rules and to properly regulate their members.[59] Further, the existence of these SROs has not prevented recent regulatory problems in their industries.[60] The ICAA questions whether, given this history, the record of effective oversight by self-regulatory organizations has been made.

An SRO would also be extremely costly for advisers. We understand, for example, that NASD membership can cost from at least five thousand dollars annually for the smallest firms to hundreds of thousands of dollars annually for large firms, including annual assessments, registration fees for each applicable employee, examination fees, training fees, and filing fees. In addition to these annual fees are added the continued costs of complying with rigid, detailed requirements. Advisers could better spend these funds to hire and retain high quality compliance personnel and enhance internal controls and risk management processes. In addition, an SRO brings with it the risk of inconsistency of interpretive positions and the potential regulatory and industry costs that accompany such inconsistency.[61]

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[57] The Commission's funds and efforts would be better spent in hiring and training inspection staff and maintaining its well-functioning direct regulation of advisers.

[58] Nor should the SEC consider using an existing SRO for this purpose. As we have previously argued (*see Statement of David G. Tittsworth, ICAA,* SEC Division of Investment Management Roundtable on Investment Adviser Regulatory Issues (May 2000)), the NASD, which has previously indicated interest in regulating advisers, is an inappropriate choice. Among other problems, the NASD would be faced with overwhelming conflicts of interest in attempting to regulate both advisers and brokers.

[59] *See, e.g., Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market* (August 8, 1996); *In the Matter of the New York Stock Exchange, Inc.*, Release No. 34-41574 (June 29, 1999).

[60] *See, e.g., SEC, NY Attorney General, NASD, NASAA, NYSE, and State Regulators Announce Historic Agreement to Reform Investment Practices,* SEC Release No. 2002-179 (Dec. 20, 2002); *Chairman Pitt Seeks Review of IPO Process*, SEC Release No. 2002-127 (Aug. 22, 2002); *Behind Weill's Almost Directorship at NYSE*, by Charles Gasparino and Randall Smith, Wall Street Journal at C1 (March 25, 2003) (discussing current corporate governance problems at NYSE); House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Hearing entitled *Analyzing the Analysts* (June 14, 2001).

[61] *See, e.g.,* NASD Rule Filing: Proposed Rule Change Concerning Related Performance Information, File No. SR-NASD-98-11 (Feb. 12, 1998) (reflecting five-year stalemate between the SEC and NASD over the use of related performance information in advertising).

4. An SRO would require legislation passed by Congress.

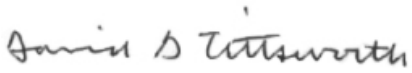
Significantly, the SEC lacks rulemaking authority to create an SRO without Congressional action. The SROs for the brokerage and accounting industries were created by acts of Congress, not by SEC rulemaking. We have been unable to identify any provision of the Advisers Act or the Investment Company Act that would authorize the SEC to create an SRO through rulemaking. More importantly, the Commission and its staff have themselves recognized that the Commission does not have authority to create an SRO without legislation enacted by Congress.[62]

CONCLUSION

We concur with the Commission's goal of enhancing compliance programs for investment advisers. Accordingly, we support the SEC's initiative to encourage compliance policies and procedures, with the modifications discussed above. The Commission has done a remarkable job in directly regulating the investment adviser profession and we do not believe radical reform of adviser regulation is necessary or advisable. Thus, we oppose an SRO for investment advisers and find no compelling reason to require third party reviews, expanded audits, or fidelity bonding.

We would be pleased to work with the Commission and its staff to encourage the compliance efforts of investment advisers and to study potential modifications to adviser regulation. Please do not hesitate to contact me if you have any questions or require additional information.

Sincerely,



David G. Tittsworth
Executive Director

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[62] *See Proposed Rule: Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Release No. IA-1862, File No. S7-10-00 (April 5, 2000) at n.12 and accompanying text (In appointing NASD operator of the IARD, the Commission stated that NASD will not "act as a self-regulatory organization for advisers … Only Congress can grant such authority"). *See also* Division of Investment Management: SEC Roundtable on Investment Adviser Regulatory Issues (May 23, 2000) (transcript of remark by Robert E. Plaze, Associate Director, SEC Division of Investment Management: "Legislation would be required to make a SRO. The SEC could not do that under our statutory scheme by ourselves").

cc: William H. Donaldson
Cynthia A. Glassman
Harvey J. Goldschmid
Paul S. Atkins
Roel C. Campos
Paul F. Roye
Lori A. Richards

ICAA

April 21, 2003

By facsimile and U.S. Mail

Mr. Jose Adam Trevino
Chairman
Texas State Securities Board
P. O. Box 13167
Austin, Texas 78711-3167

Re: House Bill 1840 and Senate Bill 1060

Dear Mr. Trevino:

The Investment Counsel Association of America[1] appreciates the opportunity to share its concerns with respect to two proposed bills introduced in the Texas legislature: House Bill 1840 and Senate Bill 1060. We understand that the Texas State Securities Board (Board) may discuss these bills at its next Board meeting. We take this opportunity to express the ICAA's strong opposition to both bills and to urge the Board to oppose passage of the bills.

House Bill 1840

House Bill 1840, if passed, would authorize the Texas Securities Commission to raise registration and notice filing fees in Texas. In particular, House Bill 1840 authorizes the Board to establish and set the fees in amounts that are reasonable and necessary so that the fees, in the aggregate, "produce sufficient revenue to cover the costs of administering and enforcing the Act." The ICAA opposes such a fee increase for several reasons. First, Texas currently charges the highest aggregate fees in the nation for registration or "notice filing" of investment advisers and investment adviser representatives. For example, the current investment adviser representative renewal fee of $220 in Texas is over four times the average in other states. Second, we note that the aggregate filing fees currently paid by the securities industry generate more than enough funds sufficient to cover the costs of administering and enforcing the State Securities Act. According to the *Supplement to the Annual Report* (August 31, 2002) published by the Board, the Board raised in excess of $98 million more than its cost of operations. Clearly, the Board's operations would not be jeopardized by any changes in existing fees. In fact, the Board has been a net contributor to the State in every year since its creation.

[1] The Investment Counsel Association of America, Inc. is a not-for-profit organization that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA's membership today consists of about 300 federally registered advisory firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. For more information about the Association, please see our web site at www.icaa.org.

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For these reasons, the ICAA strongly opposes House Bill 1840 and urges the Board to oppose this bill.[2]

Senate Bill 1060

Senate Bill 1060, if passed, would subject to criminal penalties any person rendering services as an investment adviser who fails to register or notice file and pay fees under the State Securities Act. In particular, Senate Bill 1060 (Section 3(I)) states that any person who fails to submit a notice filing as required by the State Securities Act "shall be considered guilty of a felony and on conviction of the felony shall be sentenced to pay a fine of not more than $5,000 or imprisonment in the penitentiary for not less than two or more than 10 years . . ."

The ICAA objects to imposing criminal penalties on firms federally registered with the Securities and Exchange Commission that simply fail to notice file and pay the applicable fees. Imposing criminal penalties on such individuals would be contrary to the spirit and intent of the National Securities Markets Improvement Act of 1996 (NSMIA). As you know, NSMIA divided regulatory responsibility between the SEC and the states. NSMIA broadly preempted state regulation of investment advisers registered with the SEC. However, to provide states with some notice of SEC-registered advisory firms with business in their state above a certain *de minimis* level, NSMIA permits states to require a "notice filing" and accompanying fee from such firms.[3] A "notice filing" by an SEC-registered investment adviser with a state consists simply of providing the state with a copy of its registration document that has already been electronically filed with the SEC, and which is publicly available on the Internet. To notice file that document with one or more states, an adviser electronically checks a box next to the state's name on the form and pays the fee. Thus, a notice filing has no substantive regulatory implications, but simply provides duplicate notice to states. There is no justification to criminalize the failure to provide such duplicate notice. Significantly, for these reasons, the drafters of the Uniform Securities Act of 2002 decided to carve out the notice filing provisions from its criminal liability provisions.[4] Accordingly, the ICAA urges the Board to oppose Senate Bill 1060.

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[2] We understand that you have received a similar request from Tamara Salmon, Senior Associate Counsel of the Investment Company Institute. The ICAA fully supports the ICI's letter.

[3] Contrary to the vast majority of states that comply with the *de minimis* threshold of six or more clients, Texas investment adviser rules provide advisers with no margin for error on notice filing because they require notice filing where a firm has only one client in Texas.

[4] *See* Section 508 of the Uniform Securities Act (2002). We encourage the Board to consider supporting adoption of the Uniform Securities Act in Texas, as this Act provides important investor protection enhancements and promotes uniformity and coordination among state securities laws and federal and state agencies.

We truly appreciate your consideration of these important issues. Please do not hesitate to contact me or Rasha Elganzouri, ICAA Counsel, if you have any questions or require any further information regarding the matters addressed in this letter.

Sincerely,

KAREN L. BARR
General Counsel

cc: Nicholas C. Taylor
Kenneth W. Anderson
Jack D. Ladd
Bryan K. Brown
JoAnn Kocurek

May 6, 2003

The Honorable William Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Dear Chairman Donaldson:

The Consumer Federation of America,[1] Fund Democracy,[2] the Investment Counsel Association of America,[3] the Financial Planning Association,[4] Certified Financial Planner Board of Standards, Inc.,[5] and the National Association of Personal Financial Advisors[6] are writing to urge the Commission to give renewed consideration to a long-pending rule proposal that would inappropriately expand the broker-dealer exemption from the Investment Advisers Act. The Advisers Act excepts from the definition of "investment adviser" a broker or dealer "whose performance of advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." In 1999, the Commission proposed that a broker-dealer would not be deemed an investment adviser based solely on its receipt of special compensation (such as fees based on managed assets) if it does not exercise investment discretion over the accounts from which it receives special compensation, any advice provided with respect to those accounts is solely incidental to brokerage services provided, and it employs

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[1] The Consumer Federation of America (CFA) is a nonprofit association of approximately 300 pro-consumer organizations. It was founded in 1968 to advance the consumer interest through advocacy and education.

[2] Fund Democracy is a nonprofit membership organization that acts as an advocate and information resource for mutual fund shareholders.

[3] The Investment Counsel Association of America is a not-for-profit association that represents the interests of investment advisory firms. Founded in 1937, the ICAA's membership today consists of about 300 SEC-registered companies that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. See www.icaa.org for more information.

[4] The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms, with approximately 29,000 members. Most FPA members are affiliated with investment adviser firms registered with either the SEC or state securities administrators, or both.

[5] Founded in 1985, Certified Financial Planning Board of Standards, Inc. (CFP Board) is a nonprofit professional regulatory organization that fosters professional standards in personal financial planning so that the public values, has access to, and benefits from competent and ethical financial planning. CFP Board currently authorizes more than 41,500 individuals to use its marks CFP® and Certified Financial Planner™ in the United States.

[6] NAPFA is the largest membership organization of independent, Fee-only, comprehensive financial advisors in the United States.

a disclaimer in advertising.

Although we approach this issue from very different perspectives, our organizations are united in our views: (1) that there are serious problems with the rule as proposed, and (2) that it is inappropriate for the Commission to continue to rely on the no action position it took, pending final adoption, when it issued the rule proposal more than three years ago.[7] We urge you to take up this issue without further delay.

Most of our organizations have submitted extensive and detailed comments to the Commission (copies of which are included in this packet) in response to the proposed rule. If you review those comments, you will see that, while we may disagree over various details, we agree on far more.

Most importantly, our organizations agree that, if the Commission wishes to rely on nature of services rendered rather than method of compensation as the key means of distinguishing between brokers and advisers, it must clarify what constitutes "solely incidental" investment advice by a broker-dealer. The recent blurring of lines between brokers and advisers, accelerated but certainly not initiated by the move toward fee-based broker compensation, has made action in this area imperative.

Emboldened by Commission inaction, brokerage firms aggressively advertise their services based on the advice offered and constantly seek to extend the reach of the solely incidental exemption, even to such clearly advisory services as financial planning. One result is that financial professionals who are indistinguishable to investors based on the titles they adopt, the way they market themselves, and the services they claim to offer are subject to very different regulatory regimes. Another result is that consumers are left in the dark about conflicts of interest that can exist, even with fee-based accounts, when those accounts are offered by a broker. Clearly, neither result is in investors' best interests.

The proposed rule combines this error of omission – failing to provide guidance on what constitutes solely incidental advice – with several errors of commission. These include its inconsistent treatment of discretionary accounts, its failure to rein in misleading advertising practices, and its weak advertising disclosure requirements. In revising the rule, we therefore urge you, at a minimum:

- to define what constitutes "solely incidental" advice by a broker and to do so in a way that is consistent with Congress' clear intent to limit the advice brokers can offer without triggering the protections of the Advisers Act;
- to require that all discretionary accounts be treated as advisory accounts, regardless of the method of compensation;

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[7] "Until the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise investment discretion as subject to the Act." Proposal at 4.

- to prohibit brokers who claim the "solely incidental" exemption from marketing their services as advisory services; and
- to require prominent disclosure of all material facts regarding any advice offered through the account, including but not limited to, the solely incidental nature of such advice.

Investor advocates and representatives of the investment adviser and financial planning communities are not alone in raising these concerns. These same issues were addressed by the state securities regulators in the North American Securities Administrators Association's comment letter on the proposed rule. Specifically, NASAA's comment letter: recommends that the Commission "set out factors for determining when advice is 'solely incidental;'" asserts NASAA's view that "all discretionary accounts of broker-dealers, regardless of how compensation is paid, should be treated as advisory accounts and subject the broker to the requirements of the Advisers Act;" and suggests that the Commission amend the proposed rule "to specifically preclude a broker-dealer from suggesting that the account is anything other than a brokerage account or that advisory services are also available."

We certainly understand that the Commission has had a full agenda of pressing matters to address in the past year and a half and that issues such as this were, of necessity, pushed to the back burner during that time. However, the Commission's no-action position on this issue cannot be allowed to stand indefinitely. We believe the time has come for the Commission to act. We look forward to working with you to achieve a final rule that ensures investors relying on financial professionals who offer investment advice will receive the vital protections Congress intended, regardless of whether the advice comes from a traditional money manager, a financial planner, or a broker.

We would greatly appreciate the opportunity to meet with you to discuss these issues in more detail. Meanwhile, thank you for your attention to our concerns.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America
(719) 543-9468

David G. Tittsworth
Executive Director
Investment Counsel Association of America
(202) 293-4222

Mercer Bullard
President and Founder
Fund Democracy
(662) 915-6835

Duane Thompson
Director of Government Relations
Financial Planning Association
(202) 626-8771

Michael Herndon
Director, Public & Government Affairs
CFP Board
(703) 414-5814

Susan M. John, CFP
Government Affairs Liaison
National Association of Personal
Financial Advisors
603-569-1994

cc: Commissioner Cynthia Glassman
Commissioner Harvey Goldschmid
Commissioner Paul Atkins
Commissioner Roel Campos
Paul Roye, Director, Division of Investment Management
Cynthia M. Fornelli, Deputy Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management

ICAA

June 12, 2003

Via Electronic Filing

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

Re: Solicitation of Public Views Regarding Possible Changes to the Proxy Rules, Release No. 34-47778, S7-10-03

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments in response to the Securities and Exchange Commission's Solicitation of Public Views Regarding Possible Changes to the Proxy Rules.[2] In particular, we write to suggest that the Commission address the effect of the beneficial ownership reporting rules on shareholder communications.

Pursuant to Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 ("Exchange Act"), any "person" that beneficially owns more than 5% of certain individual equity securities is required to file reports with the SEC. Advisers that exercise investment discretion over portfolios of their clients generally are deemed to be beneficial owners of the securities in those portfolios for the purposes of these provisions. Thus, an adviser managing client portfolios that in the aggregate hold more than 5% of an equity security must file the required reports. Under Sections 13(d) and (g), when two or more persons act as a partnership or group for the purpose of acquiring, holding, or disposing of securities of an issuer, that group is treated as one "person" for the purpose of determining whether the 5% threshold has been crossed.[3] In addition, pursuant to Rule 13d-5(b), when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of securities of an issuer, the group formed is deemed to have acquired, as of the date of the agreement, beneficial ownership of all of the securities of the issuer owned by any such persons.

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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 approximately 300 investment advisory firms that collectively manage in excess of $3 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[2] Release No. 34-47778 (May 1, 2003).

[3] *See* Exchange Act Section 13(d)(3); Exchange Act Section 13(g)(3). *See also* Exchange Act Rule 13d-5(b)(1).

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This regulatory structure has potential implications for shareholder communications in the proxy voting context. From time to time, institutional investors, including investment advisers managing equity securities on behalf of their clients, may wish to discuss common concerns with other institutional managers holding the same security. These common concerns may relate to the performance of management, evaluations of proposed corporate actions, or subjects of various proxy proposals. For example, institutional investors may want to share views on whether a proposed spin-off of a subsidiary will have an unwelcome effect on shareholder value. If so, investors may wish to jointly approach management and present their concerns regarding the proposed spin-off. Institutional investors may want to engage in joint discussions regarding restructuring issues with management of issuers experiencing financial difficulties. Investors may wish to share opinions on whether management is acting in the best interest of shareholders with respect to other types of proposed actions as well.[4]

A number of institutional managers approaching management or agreeing to vote together on an issue of import to shareholder value is beneficial to the clients on whose behalf the managers invest. Particularly in this current corporate climate, such shareholder communications are desirable and should be encouraged. In addition, such communications may have the effect of benefiting investors who have not retained an investment manager and do not have the resources to engage in such activities.

We understand, however, that investment advisers typically feel inhibited or chilled from engaging in communications with other shareholders because such activity could be alleged to constitute the formation of a "group" under the Exchange Act and related rules. On their face, these provisions do not require that shareholders intend to change control of an issuer in order to be deemed a group, but merely an agreement to act together for a common purpose, such as voting.[5]

If an adviser were deemed to have formed a group with other shareholders with respect to an issuer's securities, the reporting requirements would be quite burdensome. In addition to being required to monitor the holdings, purchases, and sales of the securities in each of its client and proprietary accounts, the adviser would also be required to coordinate with the other members of the ostensible group to monitor information regarding the securities purchased, held, or sold in all of their client and proprietary accounts. This would be extremely cumbersome with respect to completely independent investment managers that are merely in communications with one another regarding a common purpose. In addition, an adviser's being deemed to hold large blocks of shares could restrict its ability to sell the shares held by its clients pursuant to Section 16 under the Exchange Act.[6]

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[4] Similarly, on occasion, advisers may want to negotiate as a group with an issuer regarding investments in a new class of securities, such as preferred stock or private placements, which provide these investors with certain rights such as the right to elect a director to a board seat.

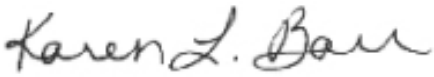
[5] *See also* Anderson, Bagnall & Smythe, *Investment Advisers: Law and Compliance*, at 12-7 (2003) (citing *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982)).

[6] Indeed, some plaintiffs' lawyers have alleged that technically for Section 16 purposes even an adviser together with certain of its clients may be deemed to be a "group" under certain circumstances, a position which is inconsistent with the intent and administrative history of this provision and with which we disagree. Litigation in various venues on these issues has injected further uncertainty into advisers' Section 13 and Section 16 analyses.

Accordingly, we respectfully request that the Commission consider amendments or interpretations to Rule 13d that would permit shareholders together holding more than 5% of a security to communicate among themselves regarding the issuer without being required to file Schedules 13D or 13G.[7] Obviously, communications by a group of shareholders for the purpose of the shareholders' making a tender offer or gaining control of the issuer would not be included in such relief.

We appreciate the opportunity to comment on these issues and would be pleased to discuss any questions the Commission or its staff may have.

Sincerely,



Karen L. Barr
General Counsel

[7] The Commission previously has offered guidance regarding circumstances under which shareholder communications may be viewed as having the purpose or effect of changing or influencing the control of an issuer and therefore would prevent a filer from being able to use Schedule 13G. *Amendments to Beneficial Ownership Reporting Requirements*, File No. S7-16-96, Release No. 34-39538 (Jan. 12, 1998). At that time, the Commission also addressed the effect of the "group" provisions of Rule 13d-5(b) on shareholder communications, but only in the context of actual proxy solicitations.

ICAA

June 19, 2003

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

RE: Research Analyst Conflicts of Interest; Notice of Filing of Amendment No. 2: File Nos. SR-NASD-2002-154 and SR-NYSE-2002-49

Dear Mr. Katz:

The Investment Counsel Association of America[1] welcomes this opportunity to share our views with respect to one aspect of the proposed amendments filed by the National Association of Securities Dealers and the New York Stock Exchange to their rules addressing research analyst conflicts of interest.[2]

ICAA members collectively manage trillions of dollars in assets for institutional and individual investors. We strongly support measures to promote the integrity and transparency of information that is provided to the public regarding issuers. The ICAA applauds efforts to address documented abuses involving certain sell-side research analysts. We comment only to request that the NYSE and NASD conform their interpretations of "research report" to the guidance provided by the Securities and Exchange Commission in adopting Regulation AC.[3]

The proposed regulations are intended to address conflicts of interest that arise when a broker-dealer that is also an underwriter or market maker produces its own

[1] The ICAA is a not-for-profit organization that exclusively represents the interests of federally registered investment adviser firms. Founded in 1937, the ICAA today consists of about 300 SEC-registered adviser firms that collectively manage in excess of $3 trillion in assets for a wide variety of institutional and individual clients. For additional information, please consult our web site: www.icaa.org.
[2] *Self-Regulatory Organizations: Notice of Filing of Amendment No. 2 to Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344 ("Supervisory Analysts"), 345A ("Continuing Education for Registered Persons"), 351 ("Reporting Requirements") and 472 ("Communications with the Public") and by the National Association of Securities Dealers, Inc. Relating to NASD Rule 2711 ("Research Analysts and Research Reports")*, SEC Release No. 34-47912; File Nos. SR-NYSE-2002-49; SR-NASD-2002-154 (May 22, 2003).
[3] Securities and Exchange Commission, *Final Rule: Regulation Analyst Certification*, Release Nos. 33-8193; 34-47384; File No. S7-30-02 (Feb. 20, 2003).

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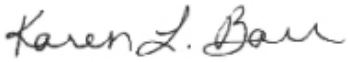
research. As we stated in our letters to the Commission regarding Regulation AC,[4] we strongly submit that the regulations governing research analyst conflicts of interest should not apply to the activities of investment advisers or investment advisory personnel. We therefore applaud the NYSE and NASD for clarifying that the term "research analyst" would not include "investment advisers, including fund portfolio managers, who are not principally responsible for preparing the substance of a research report even if they are registered persons of members."[5]

We are concerned, however, that the pending proposed definition of a "research report" does not include the requirement that a research report include a "recommendation." The inclusion of a recommendation was a significant limiting factor with respect to investment advisers, who generally do not make investment recommendations to the general public. In response to concerns regarding this definition in the context of Regulation AC, the SEC included in the adopting release a list of communications that would generally not be considered "research reports." Of importance to advisers, the list included "periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients discussing past performance or the basis for previously made discretionary investment decisions."[6] This result is appropriate because these types of communications do not present the potential for conflicts of interest that the proposed rules are intended to address. In addition, we submit that it would assist both regulators and regulated entities to ensure consistency in the interpretation of these terms.

Accordingly, we respectfully request that the NASD and NYSE follow the interpretive guidance set forth by the SEC regarding the term "research report." We also support the comments submitted today on this issue by the Investment Company Institute. We welcome the opportunity to discuss this subject in greater detail with the Commission or its staff. Please do not hesitate to contact me if you have any questions regarding these issues.

Sincerely,



Karen L. Barr
General Counsel

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[4] Letter from David G. Tittsworth , Executive Director, ICAA, to Harvey L. Pitt, Chairman, Securities and Exchange Commission, dated January 13, 2003; Letter from David G. Tittsworth, Executive Director, ICAA to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated September 23, 2002.
[5] NASD Notice to Members 02-39 (July 2002); NYSE Information Memo No. 02-26 (June 26, 2002).
[6] *See* Note 3, *supra.*

ICAA

July 2, 2003

Via Electronic Mail

Judith R. Starr, Chief Counsel
Office of the Chief Counsel
Financial Crimes Enforcement Network
Department of the Treasury
P.O. Box 39
Vienna, Virginia 22183

Re: Section 352 Investment Adviser Rule Comments

Dear Ms. Starr:

The Investment Counsel Association of America[1] appreciates the opportunity to comment on the Department of Treasury Financial Crimes Enforcement Network's proposal[2] to require certain investment advisers that manage client assets to establish an anti-money laundering (AML) program pursuant to Section 352 of the USA Patriot Act.[3] Investment advisers covered by the Proposal would be required to establish an AML program that includes four minimum requirements: (i) the development of internal policies, procedures, and controls; (ii) the designation of a person or persons responsible for the AML program; (iii) an ongoing employee training program for appropriate persons; and (iv) independent testing of compliance. The proposed rule would also delegate FinCEN's authority to examine investment advisers for compliance with these requirements to the Securities and Exchange Commission (SEC).

The ICAA recognizes the importance of preventing and detecting international money laundering and the financing of terrorism. We strongly support Treasury's efforts to implement effective and flexible regulations to assist financial institutions in developing policies and procedures to detect and prevent the use of their facilities, products, and services by money launderers. Since the passage of the USA Patriot Act, the ICAA has engaged in a dialogue with officials from the Treasury, the SEC and other agencies to

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[1] The Investment Counsel Association of America is a not-for-profit organization that exclusively represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA today consists of about 300 federally registered advisory firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. For more information about the Association, please see our Web site at www.icaa.org.

[2] Financial Crimes Enforcement Network (FinCEN); Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg. 86 (May 5, 2003) (the "Proposal").

[3] Pub. L. No. 107-56, 115 Stat. 272 (2001) ("USA Patriot Act").

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discuss the application of such regulations for investment advisers. In particular, we shared our concern that aspects of the regulations may not be appropriate for advisers because of the nature of the investment advisory profession. We urged that any regulations covering investment advisers provide substantial flexibility, especially with respect to small advisers. We also suggested that advisers be able to rely on other financial institutions already subject to AML program requirements.

We are pleased that the regulations proposed by FinCEN have adopted a risk-based approach to AML compliance. Such an approach is essential to providing investment advisers the flexibility needed to tailor their AML efforts to fit the nature and scope of their business. We take this opportunity to discuss the practical implications of various aspects of the Proposal and recommend modifications appropriate to the characteristics of the advisory profession.

Background on the Investment Advisory Profession

In the traditional advisory model, the investment adviser provides continuous and regular supervision or management of its clients' securities portfolios based on a written contract executed by each client and the investment adviser. Investment advisers are usually compensated based on a percentage of assets under management, not on a transactional basis. This structure promotes a long-term relationship between client and adviser and helps to align the interests of the adviser with the client. Most of these advisers are given authority by their clients to manage their assets on a "discretionary" basis – that is, to make investment decisions on behalf of the client within the guidelines, needs, and objectives of the client without contacting the client for permission before each transaction.

The vast majority of advisory relationships are entered into to achieve long-term investment objectives. In order to implement a selected investment strategy that achieves these objectives, the portfolio manager needs to know that the assets will remain in the custodial account and that the client will not be withdrawing or depositing significant amounts that would interfere with the strategy.[4] Thus, it is unlikely that a person would deem a discretionary advisory relationship to be an attractive vehicle for money laundering.

One of the most important distinctions between investment advisers and other financial institutions is that investment advisers typically do not actually hold a client's assets or serve in a custodial capacity. Instead, the client or adviser selects a custodian – typically a bank or broker-dealer – to hold client funds and securities. The client opens an account with the custodian and authorizes the custodian to accept investment instructions from the adviser. The adviser typically does not have the opportunity to view how the client's account is funded or where withdrawals from the account are sent.[5]

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[4] *Cf. Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*. 67 Fed. Reg. 187 at 60619 (September 26, 2002) (noting that entities requiring lengthy investment periods are less susceptible to money laundering).

[5] The adviser may have communications with the custodian regarding settlement problems or issues that arise during the reconciliation process. These communications, however, generally involve specific

Although the investment advisory profession manages in aggregate approximately $18 trillion in assets on a discretionary basis, the 274 largest investment advisory firms manage 80 percent of these assets.[6] As FinCEN recognizes, most investment advisory firms are relatively small in size with few employees: only ten percent of federally registered advisers reported having more than 50 employees, "whereas nearly half reported having one to five employees."[7] The clientele of SEC-registered advisers is also quite diverse, including individuals, banks, mutual funds, pension funds, hedge funds, charitable organizations, corporations, and state or municipal entities.

Discussion

I. Scope of Proposal

The Proposal notes that in some instances, investment advisers manage pooled investment vehicles that are themselves required to maintain AML programs under the Bank Secrecy Act (BSA) rules, such as mutual funds. In order to prevent overlap and redundancy, the Proposal would permit investment advisers to exclude from their AML programs "any [pooled] investment vehicle they advise that is subject to an anti-money laundering program requirement under BSA rules." The Proposal further explains that advisers may exclude pooled investment vehicles that are sponsored or administered by financial institutions.

The ICAA applauds FinCEN for adopting this approach to avoid unnecessary duplication of efforts among financial institutions. We note, however, that the actual text of the proposed rule does not clarify that the exclusion extends to pooled investment vehicles that are *sponsored or administered by financial institutions subject to BSA requirements*. We recommend that the final rules reflect this added language.

In addition, there are certain pooled investment vehicles that, although not subject to existing or proposed BSA program requirements, are not likely to pose a significant money laundering risk and therefore may be excluded entirely from the adviser's AML program. In the proposed AML program rules for unregistered investment companies, FinCEN expressly excludes the following companies from the definition of an "unregistered investment company" that would be subject to BSA rules: (1) companies that permit redemptions only after two years from the date of purchase and (2) companies that have total assets of less than $1,000,000 as of the most recently completed calendar quarter.[8] FinCEN has recognized that these types of companies are "not likely to be used

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trades initiated by the adviser and do not involve how the client's account is funded, where moneys are wired, or information about other accounts the client may have with the custodian. We understand that, in limited circumstances, some small advisers with individual clients may transmit withdrawal instructions from the client to the custodian as a courtesy to the client and thus would know where the money is transmitted in those instances.

[6] ICAA/NRS, *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* (May 2003) at 3 ("Evolution/Revolution Report"). The vast majority of large investment advisory firms are associated with a broker-dealer, bank, or investment company and therefore already are dealing with AML issues.

[7] Proposal at 10; *see also* Evolution/Revolution Report at 4.

[8] *See* FinCEN; Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 187 (September 26, 2002) at 60620.

by money launderers."[9] Similarly, we recommend that investment advisers be permitted to exclude these types of pooled investment vehicles from their AML program procedures.

Similarly, we recommend that investment advisers be afforded the same opportunity to exclude offshore funds located in FATF-compliant jurisdictions from their AML programs. An investment vehicle organized in a FATF-compliant jurisdiction is already subject to AML rules applicable to such vehicles. We submit that regulatory regimes that are consistent with FATF standards are substantially similar to the BSA regulatory structure.[10] There is no reason for an adviser to develop an additional layer of AML policies and procedures for these offshore funds.

II. Development of Policies and Procedures

An investment adviser subject to the Proposal would be required to develop and implement its own AML program reasonably designed to prevent the firm from being used to launder money or finance terrorist activities. Every AML program must incorporate four minimum requirements:

(i) the development of internal policies, procedures, and controls;
(ii) the designation of a person or persons responsible for implementing and monitoring the program;
(iii) an ongoing training program for appropriate persons; and
(iv) independent testing of compliance to be conducted internally or by an outside party.

As with other financial institutions subject to AML program requirements, the Proposal affirms that each adviser has the flexibility to tailor its program to fit its business, taking into account factors such as size, location, activities, and risks or vulnerabilities to money laundering. As noted in the Proposal, FinCEN expects that large firms will adopt detailed procedures and smaller firms may adopt procedures consistent with their simpler, centralized organizational structure. In fact, according to FinCEN, if an investment adviser is small, the burden to comply with the proposed rule should be *de minimis*.[11]

We are pleased that the proposed regulations recognize the broad diversity within the investment advisory profession and appropriately emphasize a risk-based approach to AML compliance. Such an approach offers investment advisers much needed flexibility to tailor their AML programs to fit their business needs and resources. We agree that a small

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[9] *Id.*

[10] *See also* Managed Funds Association Letter to FinCEN re: Section 352 Unregistered Investment Company Regulations (November 25, 2002) at 6 (urging FinCEN to permit delegation of AML responsibilities to third parties located in FATF-compliant jurisdictions); SIA Letter to U.S. Department of the Treasury re: Submission to Treasury Patriot Act Task Force (March 7, 2003) (urging FinCEN to permit reliance on intermediaries subject to AML requirements in FATF-member jurisdictions and jurisdictions with similar regulatory requirements).

[11] Proposal, Section VI, Regulatory Flexibility Act, at 20. The effectiveness of the AML rule will be enhanced, while reducing burdens and costs, to the extent that the Department and other federal agencies are able to adopt coordinated processes, such as establishing a single, centralized control list against which clients could be checked.

adviser should not be required to incur significant costs to comply with the proposed rule requirements. For example, a small adviser whose only clients are individuals with a pre-existing relationship with the adviser should require relatively minimal AML policies and procedures. Such an adviser may be able to develop procedures that simply reflect the firm's awareness of the risks of money laundering and a commitment to monitor for suspicious behavior.

Similarly, we concur with FinCEN's risk-based approach as it pertains to U.S. and non-U.S. pooled investment vehicles that are not subject to BSA requirements (subject to our comments in Section I of this letter). The Proposal notes that advisers providing investment advice to pooled investment vehicles that are created or administered by a third party must conduct an assessment of the money laundering risk posed by the particular vehicle or entity that created and administered the vehicle. In these circumstances, the adviser would need to establish procedures to assess whether the entity that created and administered the vehicle, or the nature of the vehicle itself, poses significant money laundering risks. As the potential vulnerability to money laundering increases, the procedures would need to address the increased risks. We seek confirmation, however, that in assessing the risk posed by U.S. and non-U.S. pooled investment vehicles, an adviser may treat such vehicles as the "client" and will not have an obligation to "look through" the pooled vehicle to obtain information about the underlying investors.[12]

We take this opportunity to address some concerns that we have with respect to the following matters: (1) suspicious activity guidance, (2) division of AML responsibilities among financial institutions, and (3) approval of the AML program.

A. Suspicious Activity Guidance

Currently, there is no regulatory guidance on what constitutes "suspicious activity" in the investment advisory context. In the proposing release, FinCEN provides examples of areas of suspicious activity for advisers. These examples, however, are more applicable to financial institutions that have access to client funds and securities, such as banks and broker-dealers. For example, FinCEN notes that advisers' procedures would identify unusual transactions upon the subsequent withdrawal of assets from management with the firm and transfers to unrelated accounts or to accounts in countries where drugs are produced. Most investment advisers do not receive information regarding such transactions and should not be required to have procedures to identify such transactions. In fact, advisers generally will not be able to monitor how customers fund their accounts, make wire transfers to high-risk countries, engage in unusual wire activity, or request transfers to third parties.[13] Rather, the custodian of the managed assets will have primary access to the information needed to assess whether there is suspicious activity in these areas.

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[12] We are concerned that the Proposal seems to suggest otherwise. *See* Proposal at 14 (stating "[a]s the entity's potential vulnerability to money laundering increases, the adviser's procedures would need to reasonably address these increased risks, such as by obtaining and reviewing information about the identity and transactions of the investors in the vehicle.").

[13] *See* Securities Industry Association, *Preliminary Guidance for Deterring Money Laundering Activity* (Feb. 2002).

The ICAA strongly recommends that FinCEN provide guidance regarding the types of suspicious activity that are most appropriate for investment advisory firms to monitor. We provide the following as examples of potential indicators of suspicious activity that may be relevant for investment advisers:[14]

- A client exhibits an unusual concern regarding the adviser's compliance with government reporting requirements or is reluctant or refuses to reveal any information concerning business activities, or furnishes unusual or suspect identification or business documents;
- A client appears to be acting as the agent for another entity but declines, evades, or is reluctant to provide any information in response to questions about that entity;
- A client's account has a pattern of inexplicable and unusual withdrawals, contrary to the client's stated investment objectives;
- A client requests that a transaction be processed in such a manner so as to avoid the adviser's normal documentation requirements; or
- A client exhibits a total lack of concern regarding performance returns or risk.

We recommend that FinCEN substitute the above-referenced potential indicators of suspicious activity for those in the Proposal. Of course, these potential "red flags" are not dispositive. An adviser's determination of whether the activity is actually an indicator of suspicious activity will necessarily depend on the facts and circumstances regarding the particular transaction, the client, and the client's relationship with the adviser.

B. Division of AML Responsibilities Among Financial Institutions

As FinCEN notes in the Proposal, advisory clients typically have relationships with other financial institutions, such as banks and broker-dealers that are already subject to AML program requirements. In such cases, the investment adviser should only be required to monitor activities of which it is aware and should not be required to gather additional AML information from such entities that it does not already receive in the ordinary course of business.[15] We are concerned that Footnote 22 of the Proposal appears to suggest that an investment adviser would have an obligation to "coordinate review" of transactions with the custodian in situations where the adviser selects and retains the account custodian. We do not believe that such an obligation is appropriate, particularly where an adviser's client accounts may be held at dozens of custodian firms. Even when the adviser selects the account custodian, the custodian still controls all account transaction information.

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[14] *See, e.g.*, SIA Guidelines, at 12-13.

[15] Of course, in the limited circumstances where an adviser becomes aware of information that may indicate suspicious activity, the adviser may rely on the information-sharing provisions of the USA Patriot Act to coordinate with other financial institutions to assess whether a money laundering risk is present. Section 314(b) of USA Patriot Act allows financial institutions, regulatory authorities, and law enforcement authorities to share information about suspicious activities. Section 314(b) applies to all financial institutions that are required to establish an AML program. We understand that upon adoption of final AML program rules for advisers, advisers will be treated as a "financial institution" for purposes of Section 314(b).

More importantly, the custodian, as a "financial institution," is subject to bank or broker-dealer AML rules. Instead of coordination, the obligation suggested by the footnote would result in duplication, contrary to FinCEN's stated purpose in developing the proposed rules. Similarly, an adviser that serves as one of many advisers to a particular client should only be required to monitor for account activity and respond to red flags that arise in the ordinary course of its own relationship with the client.

We suggest two additional relationships where an adviser's efforts would be duplicative of the AML efforts of other financial institutions. First, an adviser that provides subadvisory services to a registered investment adviser subject to BSA requirements (the "primary adviser") should not be required to include the subadvised clients of the primary adviser in its AML program.[16] The primary investment adviser will already have conducted due diligence regarding the clients and, for monitoring purposes, will have all of the relevant information that the subadviser may also have. Similarly, an adviser in a wrap account program should not be required to include the wrap account clients in its AML program. The sponsors of wrap programs are broker-dealers subject to BSA requirements and/or registered investment advisers that will be subject to BSA requirements. In these programs, the sponsor has the primary relationship with the clients, has already conducted know-your-customer procedures for these clients, and has the ability and obligation to monitor account activity. Advisers generally have little or no personal contact with wrap account clients and instead make the investment decisions for the client based on the suitability analysis conducted by the sponsor. Accordingly, there would be no value added by requiring advisers to conduct duplicate due diligence on these clients or to monitor the same transactions monitored by the sponsor.

By the same token, we recognize that with respect to individuals and institutions as to which an investment adviser has the primary relationship, the adviser should be responsible for knowing the client and monitoring of the type described above.

Finally, we understand that if an adviser retains a service provider or vendor to conduct part of its AML program (for example to gather information about clients or to review the adviser's documents to monitor for suspicious activity), the adviser retains responsibility for the effectiveness of the AML program and must take reasonable steps to assess the competency of the service provider to carry out the program. There has been some confusion in the industry, however, between the concept of "delegating" one's own AML functions to a service provider (and retaining ultimate responsibility) and "reliance" on the fact that other financial institutions subject to BSA requirements that share the same client with the adviser have already included that client in their AML program. In the latter situation, we seek confirmation that the adviser does not retain responsibility for the effectiveness of the AML program of other financial institutions and does not need to conduct due diligence on the financial institution's AML program.

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[16] Similar to our request in Section I regarding offshore pooled vehicles, we request that an adviser be permitted to rely on the AML efforts of advisers in FATF jurisdictions with respect to subadvised accounts in non-U.S. jurisdictions.

C. Approval of AML Program

The Proposal would require that each investment adviser's program be approved in writing by the board of directors or trustees or, if it does not have one, by its sole proprietor, general partner, or other persons who have similar functions. We concur with the intent to have high-level support within the firm for approval of the AML program. We note, however, that owners or principals are probably not the appropriate parties for program approval. We recommend instead that FinCEN's final rules permit approval by a member of senior management, consistent with the corresponding rules for broker-dealers.[17]

III. Designation of AML Officer

The Proposal requires that advisers designate a person (or group of individuals) responsible for implementing and monitoring the operations and internal controls of the AML program. The person or persons should be competent and knowledgeable regarding applicable requirements and money laundering risks. The ICAA supports this aspect of the Proposal but seeks clarification with respect to FinCEN's statement that "the person responsible for overall supervision of the AML program should be an officer of the investment adviser." We note that many advisers may not have "officers" *per se*. Instead, the final release should acknowledge that a person responsible for overall supervision of the AML program should be a member of senior management or report directly to senior management. This would ensure that the responsible person has adequate authority to oversee the program, while providing flexibility for a firm to appropriately structure its own operations.

IV. Independent Testing Function

The Proposal requires investment advisers to establish independent testing of the AML program to be conducted internally by employees of the advisory firm or by outside auditors. Personnel conducting the testing should have a working knowledge of applicable BSA requirements but should not be the person designed to implement or monitor the AML program. We applaud FinCEN for clarifying that the independent testing function is simply testing, and not necessarily a full-blown "audit" of the AML program.

Nevertheless, we are extremely concerned with the cost and burden of such a requirement, particularly for small advisers. Most investment advisory firms are relatively small in size with few employees. According to our most recent report, a total of 3,859 or 49 percent of federally registered advisers have only between one and five employees. Indeed, 5,299 or 67 percent of all SEC-registered advisers have ten or fewer employees.[18] The staffs of such advisers are not likely to include personnel who are knowledgeable regarding BSA requirements but are not already involved in implementing the AML program. Accordingly, it will be very difficult for these small firms to conduct a test internally under rigid definitions of independence. Perversely, the smallest firms that can

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[17] Proposed Rule Change by National Association of Securities Dealers, Inc., Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934, File No. SR-NASD-2002-24, at 18.

[18] Evolution/Revolution Report at 5.

least afford it will be the firms that need to hire outside consultants for an audit. The cost for an external audit could be significant, especially for small advisers. This is contrary to FinCEN's assumption that the Proposal will "not have a significant economic impact on a substantial number of small entities."[19]

Given that advisers typically do not hold client funds or assets, we suggest that the adopting release provide flexibility in this area.[20] For example, we seek confirmation that small advisers will be permitted to employ an internal testing regime that may include personnel involved in the firms' ongoing BSA compliance. In addition, we appreciate the flexibility provided in the Proposal regarding frequency of testing and seek confirmation that certain firms, such as those with a relatively stable client base, may reasonably choose to conduct testing on a less-than-annual basis, such as every two-three years.

V. Delegation of Compliance Enforcement to SEC

The Proposal notes that FinCEN has delegated examination authority to the SEC. The ICAA supports this delegation of authority because the SEC is the appropriate functional regulator for SEC-registered investment advisers. We anticipate that examination of AML compliance will be integrated into the SEC's general examination program.

VI. The Compliance Date and Related Issues

The Proposal requires an adviser to establish and implement its AML program within 90 days of adoption of the final rules. We are concerned that firms may have difficulty meeting this compliance date and request that the final rules allow for a longer compliance period.

The proposed rules impose new and significant responsibilities on advisers. The development and implementation of policies and procedures to ensure compliance with the new rules will be time-consuming. Depending on each firm's particular characteristics, investment advisers may have to change their advisory agreements and implement new operational and compliance procedures to comply with the proposed rules. In addition, advisers will have to spend a considerable amount of time training employees about BSA requirements. In some instances, especially for smaller firms that do not employ a full-time compliance officer, an adviser may have to spend significant time educating its compliance officer regarding BSA rules. Accordingly, we recommend that FinCEN allow an adviser to establish and implement its AML program within 180 days after final rules are adopted.

In addition, we understand that any new AML rules for investment advisers will have prospective application only; that is, advisers will not be required to implement

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[19] Proposal at 20.

[20] We note that the SEC does not require registered investment advisers to conduct an independent test of their policies and procedures. Instead, advisers have discretion to determine the frequency and manner in which to evaluate their procedures, subject to SEC inspection. Advisers typically internally review their policies and procedures periodically and on an ongoing basis to ensure compliance with SEC regulations.

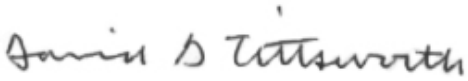
know-your-customer procedures with respect to existing clients and will not be required to review transactions that had already occurred at the time of rule adoption. We respectfully request that a statement to that effect be included in the final rules.

Finally, we understand that the Treasury Department has created a task force to study the costs incurred by firms of complying with the new anti-money laundering rules of the USA Patriot Act. We strongly support Treasury's efforts to assess the costs and benefits of continuing AML compliance and we urge the Department to consider less restrictive requirements in the future in the absence of meaningful cost-benefit data.

Conclusion

We truly appreciate your consideration of our comments on this important Proposal. We trust that you will not hesitate to contact us if we may provide any additional information or assistance to you during this process.

Sincerely,



David G. Tittsworth
Executive Director

cc: Charles D. Klingman
Paul F. Roye

ICAA

July 7, 2003

Via Electronic Delivery

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

Re: Comments on the Hedge Fund Roundtable, File No. 4-476

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates this opportunity to provide written comments to the Commission regarding its recent Hedge Fund Roundtable.[2]

The ICAA commends the Commission for the thoughtful and deliberate approach being taken with respect to issues involving the hedge fund industry.[3] The recent roundtable produced an excellent record on a number of relevant issues that will assist the Commission and other policy makers in considering any potential actions that can and should be taken. Recent Congressional hearings also have contributed to this outstanding effort.[4] In conjunction with the fact-finding activities of the Commission's Division of Investment Management and the Office of Compliance Inspections and Examinations during the past year, these and other informational proceedings have helped to create an impressive body of evidence and recommendations on which the Division's forthcoming report will be based.

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[1] The ICAA is a not-for-profit association that represents the interests of the registered investment advisory profession. Founded in 1937, the ICAA's membership today consists of about 300 SEC-registered investment advisory firms that collectively manage in excess of $3 trillion for a wide variety of institutional and individual clients. See www.icaa.org for more information.

[2] *In the matter of: Hedge Fund Roundtable, File No. 05-007-03;* before the Securities and Exchange Commission (May 14-15, 2003).

[3] The term "hedge funds" generally refers to pooled investment vehicles that are privately organized, administered by professional money managers, and not widely available to the public. *See* The President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (1999).

[4] *See e.g., "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk,"* Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (May 22, 2003); "*Recent Developments in Hedge Funds,"* Committee on Banking, Housing, and Urban Affairs (April 10, 2003).

After our review of these matters, the ICAA agrees with other parties and organizations that have recognized and underscored the importance of the hedge fund industry. Hedge funds offer a number of potential benefits to eligible investors by providing an effective alternative investment strategy that may reduce portfolio risk, increase investment returns during difficult market or economic conditions, and allow for participation in non-traditional products and markets. Hedge funds offer potential benefits to the marketplace by contributing to its overall efficiency. The ICAA strongly believes that hedge funds play an important role in the global financial services marketplace and that the Commission should be cautious in taking actions that unnecessarily stifle the innovation and risk-taking characteristics that are hallmarks of appropriate hedge fund activities.

We nonetheless are mindful of various concerns that have been raised and wish to highlight a few key issues for consideration by the Commission.

Need for Better Information and Accountability

While we acknowledge that hedge fund activities already may be subject to various regulations,[5] these filings do not provide sufficient information for an adequate regulatory assessment of the hedge fund industry on an ongoing basis. The ICAA believes the SEC and other regulators should have better information regarding the characteristics of hedge funds, including the size and number of investors involved in each fund. Currently, there is no legal requirement that hedge funds submit any identification or contact information to the Commission or other regulators.[6] Common sense and compelling policy considerations support the conclusion that hedge fund managers should, at a minimum, be subject to a basic informational filing requirement. The absence of any filing requirement will continue to make it very difficult for the Commission effectively to fulfill its missions of protecting investors and maintaining orderly markets. Presumably for these reasons, regulators in other comparable jurisdictions, including the United Kingdom and France, require hedge funds or their managers to register.[7]

As the Long-Term Capital Management situation vividly demonstrated, hedge fund failures can have a potentially enormous adverse impact on the markets. Similarly, as evidenced by the Commission's recent enforcement proceedings, hedge funds and their managers can engage in fraudulent, deceptive, and manipulative activities that are harmful to investors. While we believe these unfortunate situations represent relatively

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[5] *See Comments of Managed Fund Association for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds* (May 6, 2003).

[6] Pursuant to anti-money laundering regulations proposed by the Department of Treasury, certain hedge funds would be required to file a notice that identifies themselves, provides contact information, and states the amount of assets managed and number of investors. *Financial Crimes Enforcement Network: Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 187 (Sept. 26, 2002). Due to various limitations and exceptions, this proposal would not cover all hedge funds.

[7] *See, e.g.*, *Hedge Fund Roundtable*, May 15, 2003, transcript of afternoon session (remarks of Christina Sinclair, Financial Services Authority, U.K.; Jean-Claude Delespaul, Commission des Operations de Bourse, France).

isolated incidents, we strongly believe that hedge fund managers should be subject to basic requirements to report on at least an annual basis: (1) appropriate contact and identification information, and (2) other appropriate basic information concerning their operations. For the same reasons, we believe hedge fund managers clearly should be required to submit to the jurisdiction of the Commission (or other appropriate regulator) for legitimate regulatory, oversight, and investigative reasons.

Many managers of hedge funds typically claim an exemption from registration and other requirements of the Investment Advisers Act under section 203(b)(3).[8] In examining recent registration reports from SEC-registered investment advisers, however, we found that an increasing number of hedge fund managers have made the decision to comply with investment adviser registration requirements.[9] According to our research, the number of registered advisers that provide advice to hedge funds or other pooled investment vehicles rose more than 8% during the past year, from 1,619 in 2002 to 1,762 in 2003. Similarly, the percentage of registered investment advisers reporting that they provide advice to hedge funds or other pooled vehicles has risen from 20.7% in 2001 to 21.3% in 2002 to 22.4% in 2003.[10] Significantly, the number of registered advisers reporting that hedge funds constitute more than 75% of their client base surged from 416 in 2002 to 508 in 2003.[11] We believe that this increase is at least partially due to hedge fund managers seeking to expand their client base to include the types of institutional clients that require any managers they retain to be registered as investment advisers.

The registration requirements of the Advisers Act require investment advisers to submit a variety of informational, operational, and other data to the Commission via Form ADV. The form also requires investment advisers to make various disclosures relating to personnel, business practices, and potential conflicts of interest. Form ADV, Part 1, which was amended by the Commission in September 2000,[12] is submitted electronically via the Investment Adviser Registration Depository and contains various questions requesting information – generally in a "check-the-box" format – pertaining to basic identification information, types of clients and services, and disciplinary history. Proposed Form ADV, Part 2, on the other hand, contemplates a narrative document suitable for existing and prospective client use that focuses more on a description of significant business practices and potential conflicts of interest.[13] Thus, Form ADV serves a number of different purposes, including those relating to a variety of regulatory

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[8] Section 203(b)(3) provides that the registration provisions of Section 203(a) shall not apply to "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company registered under title I of this Act. . . ."

[9] *See Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession*, ICAA and National Regulatory Services (May 2003). The full text of the report is available at www.icaa.org or www.nrs-inc.com.

[10] *Id*. at 1.

[11] *Id.* at 7.

[12] *See Electronic Filing by Investment Advisers; Amendments to Form ADV* ; File No. S7-10-00 (Sept. 12, 2000).

[13] The Commission has not yet taken final action on proposed amendments to Form ADV, Part 2. *See Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV;* Rel. No. IA-1862; File No. S7-10-00 (April 5, 2000).

and oversight activities of the Commission, as well as numerous investor protection and disclosure concerns.

We strongly urge the Commission to require managers of hedge funds to register as investment advisers under the Investment Advisers Act. This is clearly the single most important issue to be considered by the Commission. The bottom line is that, absent some type of mandatory registration requirement for hedge fund managers, the Commission will be unable to take appropriate steps to protect investors and maintain orderly markets.

Registration of hedge fund managers under the Advisers Act will allow the Commission to gain a better understanding of the scope, breadth, and nature of the hedge fund industry, to improve inspection, investigative, and enforcement activities related to hedge fund managers, and to determine the types of legal, regulatory, and compliance requirements that are most appropriate to the hedge fund industry. Registration will enable the Commission to have the opportunity to identify problems *before* they develop; without it, the Commission always will be relegated to the task of attempting to clean up difficult situations *after* the fact. Importantly, mandatory registration should help to foster a constructive and proactive compliance culture by all hedge fund managers. And the fact that an increasing number of hedge fund managers already are voluntarily complying with Advisers Act registration and regulatory requirements would appear to support the conclusion that such requirements are not unduly burdensome or inappropriate.

In doing so, however, we do not mean to suggest that the Commission must subject such managers to *all* registration or regulatory requirements governing investment advisers. A more limited registration and regulatory program may be more appropriate for hedge fund managers who are not already subject to registration because of their other activities. In making these difficult decisions, the Commission must engage in a balancing act that will preserve appropriate hedge fund activities and strategies (including the ability to protect certain sensitive information) while serving legitimate investor protection and other public interests.

The Commission may require registration of hedge fund managers without Congressional involvement by amending its definition of "client" under Rule 203(b)(3)-1. The rule permits a partnership or certain other entities to be treated as a single client if it receives advice based on its own investment objectives rather than the individual investment objectives of its partners or other constituents. This definition of "client" allows hedge fund managers to count the fund as one client for the purpose of determining whether they meet the 15-client threshold for registration. However, advisers widely rely on this definition in a number of additional areas.[14] Accordingly, should the Commission decide to amend Rule 203(b)(3)-1, we strongly urge that the

[14] *E.g.*, Investment Advisers Act Rule 203A-3 (permitting reliance on the definition of "client" in Rule 203(b)(3)-1 in determining whether a supervised person is an "investment adviser representative"); Investment Advisers Act Rule 222-2 (permitting reliance on Rule 203(b)(3)-1 definition of "client" for purposes of the national de minimis standard created by NSMIA).

amendment be carefully limited to the narrow purpose of requiring hedge fund manager registration and for no other purpose.[15]

Need to Protect Non-Sophisticated Investors

The Commission's roundtable also focused attention on whether the definition of "accredited investor" should be revised in any manner.

At the recent hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Chairman Donaldson clearly indicated that the Commission will consider issues related to revising the accredited investor definition:

> Although the Commission is not aware of any systematic investor losses or other failures caused by the current accredited investor standard, we could of course consider adjusting it, if warranted. In that respect, it may be appropriate to consider whether the definition should be updated to increase the levels of income or assets. It also may be anachronistic to use the definition as a surrogate for investor sophistication, and it may also be worthwhile to revisit that concept. A global change to the standard, however, could impact significantly the availability of securities registration exemptions to other companies. In particular, we would carefully consider the effect of any adjustment to the standard on the opportunities for small business capital formation before proposing any change.[16]

The current definition of "accredited investor" was established in 1982. In addition to banks and other institutional investors, the term also includes natural persons with an individual or joint net worth of $1 million or individual income in each of the last two years in excess of $200,000, or joint income for the same period in excess of $300,000.

The ICAA believes there are potential risks and complexities that may be associated with hedge fund strategies and products such that the Commission and other regulators should seek to establish and enforce rules that restrict participation in such pooled vehicles to sophisticated investors. We urge the Commission to consider revising the current definition of "accredited investor" and we agree with the considerations recently outlined by Chairman Donaldson. Considering the fact that the definition has not been revised for more than two decades (including the fact that the dollar figures have not been adjusted even for inflation), such a review is clearly warranted. While we understand and agree with the statement that income and net worth requirements do not necessarily equate with investment sophistication, we nonetheless urge the Commission to avoid revisions that would create unnecessary burdens or confusion in making a

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[15] The Commission could, for example, change the "holding out" provision of Rule 203(b)(3)-1(c) or create a special rule specifically for hedge funds under subsection (b), instead of amending subsection (a) with all of its potential collateral consequences.

[16] *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk*, written statement of William H. Donaldson, at 20, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (May 22, 2003) ("*Long and Short of Hedge Funds*").

determination or verifying that a person falls within the definition. Stated differently, we believe it is advisable to retain a "bright line" test if any revisions are made.[17]

The roundtable also discussed the so-called "retailization" of hedge funds, particularly in the context of the growth of funds of hedge funds (*i.e.* registered investment companies that invest all, or substantially all, of their assets in an underlying pool of hedge funds). Commission staff first approved such a fund in the summer of 2002. Since then about 19 other funds of hedge funds were cleared for the public market.[18] The good news about such funds is that they are clearly subject to the panoply of protections afforded investors under the Investment Company Act. On the other hand, such funds are *not* subject to any legal standard similar to the "accredited investor" standard nor are they subject to any legal minimum investment. Although it is our understanding that all such funds voluntarily have restricted investors to accredited investors and have minimum investment requirements of at least $25,000, we believe the Commission should examine whether any further action is appropriate for investor protection purposes. If the past year is any indication, future growth in such funds could be significant and we thus believe it would be desirable to consider establishing standards sooner rather than later.

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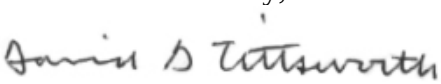
In closing, we again commend the Commission for the manner in which it is considering these and other issues relating to hedge funds. The ICAA and its membership stand ready to assist the Commission in any manner that may be helpful.

Sincerely,



DAVID G. TITTSWORTH
Executive Director

Cc: Hon. William H. Donaldson
Hon. Cynthia A. Glassman
Hon. Harvey J. Goldschmid
Hon. Paul S. Atkins
Hon. Roel C. Campos
Paul F. Roye
Annette L. Nazareth
Lori Richards

[17] At a minimum, the definition of "accredited investor" should be harmonized with the definition of "qualified client" developed for the purposes of Advisers Act Rule 205-3, the rule addressing when registered advisers may use performance fees. A "qualified client" has a $1.5 million net worth (if a natural person, together with assets held jointly with spouse) or at least $750,000 under management with the adviser.

[18] *Long and Short of Hedge Funds* at 8.

ICAA

August 4, 2003

By Electronic Filing and U.S. Mail

Maliaka Bass EssamelDin
Tennessee Department of Commerce
And Insurance, Securities Division
500 James Robertson Pkwy
Fifth Floor
Davy Crockett Tower
Nashville, Tennessee 37243

Re: Proposed Rules Regarding Registration of Investment Adviser Representatives - Chapter 0780-4-1

Dear Ms. EssamelDin:

Thank you for providing the Investment Counsel Association of America (ICAA)[1] the opportunity to comment on the Department of Commerce and Insurance's proposed amendments to its investment adviser rules, as set forth in Chapter 0780-4-1 of the Tennessee regulations. The proposed rules, among other provisions, would require registration of investment adviser representatives. The ICAA generally supports the proposed rules with modifications designed to make the rules more uniform with those of other states.

We are pleased that the proposed regulations mandate that investment adviser representatives use the IARD system for filing. The ICAA strongly supports implementation of the IARD system because it will facilitate uniform electronic filing for all investment adviser representatives.

[1] The ICAA is a not-for-profit organization that exclusively represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA today consists of about 300 federally registered investment advisory firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. Virtually all ICAA member firms have a multi-state or national business. The ICAA has been an active and consistent supporter of uniformity in the treatment of SEC-registered advisers by the various states and regulators.

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We have the following specific comments regarding the proposal:

1. **Proposed Rule 0780-4.1-.04(5)(c) - Division Records**. The proposed rule states that the Division shall make available for public inspection an investment adviser representative's Form U4 and Form U5. For privacy reasons, we oppose the public release of a registrant's personal identifying information such as social security number, home address, home phone number, and other personal information contained in Section 9 of Form U4. We submit that this information should not be made available for public inspection and request that you revise the proposed rule to reflect that certain personal information about the registrant shall remain confidential.
2. **Proposed Rule 0780-4-3.01 (9)(h)(3)(i)**. The proposed rule would exempt investment adviser representatives employed by federal covered advisers who do not have a place of business in the state from registering as an investment adviser representative in the state. We strongly support this exemption, but urge the Department to amend the exemption to track the definition of "investment adviser representative" as defined in regulations adopted under the Investment Advisers Act of 1940. Under the National Securities Markets Improvement Act of 1996 (NSMIA), states may only require the registration of a person who (1) has a place of business located in that state and (2) is deemed an "investment adviser representative" under federal law. The second requirement is not reflected in the proposed rule. Accordingly, we suggest the following language change:

   (i) An individual who is associated with an investment adviser that has filed a completed investment adviser notice filing pursuant to T.C.A. section 48-2-110(c)(2) is not required to register as an investment adviser representative of such investment adviser in this state, unless the individual has a "place of business" in this State as that term is defined by rule adopted under Section 203A of the Investment Advisers Act of 1940 and is:

   a. an "investment adviser representative" as that term is defined by rule adopted under Section 203A of the Investment Advisers Act of 1940; or
   b. not a "supervised person" as that term is defined in Section 202(a)(25) of the Investment Advisers Act of 1940.

   Importantly, this language not only conforms the rule to the requirements of NSMIA, but is also consistent with the Uniform Securities Act of 2002 (Uniform Act)[2].

[2] *See* Section 102(16) of the Uniform Securities Act (definition of an "investment adviser representative" of an SEC-registered investment adviser).

3. **Proposed Rule 0780-4-3-.02(5) - Agent and Investment Adviser Representative Reporting Requirements**. The proposed rule would require an investment adviser representative to file with the Division through its investment adviser copies of certain disciplinary actions. Because the term "investment adviser" includes federal covered advisers, such advisers would be required to comply with the reporting requirements for investment adviser representatives under this proposed rule. Under NSMIA, state authority over federally registered investment advisers is limited to requiring notice filings and fees and investigating and bringing enforcement actions for fraud and deceit. This additional reporting requirement would be contrary to the authority preserved to the states under NSMIA. Moreover, states already have access to this type of information because it is included on an investment adviser representative's Form U4. Accordingly, we respectfully request that the proposed rule be amended to provide that it applies only to investment advisers registered or required to be registered in Tennessee.

4. **Proposed Rule 0780-4-3.02(6) - Prohibited Business Practices.** The proposed rule regarding prohibited business practices applies to investment adviser representatives, rather than solely to investment adviser representatives of advisers that are state-registered in Tennessee. This proposed rule would be contrary to NSMIA as it imposes a second layer of regulation on investment adviser representatives of SEC-registered advisers. Under NSMIA, states are precluded from regulating the conduct of SEC-registered advisers and their investment adviser representatives, except to the extent those practices would otherwise constitute actual fraud or deceit. The proposed rule attempts to prohibit conduct that does not constitute fraud or deceit. In rules implementing NSMIA, the SEC correctly interpreted NSMIA to prohibit states from re-regulating SEC-registered advisers and their representatives through the back door of defining "dishonest or unethical" business practices. In fact, the SEC has expressly stated that the provision "limiting the [states'] authority to bringing enforcement actions [for fraud and deceit] precludes a state securities commission from re-regulating by issuing anti-fraud rules."[3] Accordingly, we strongly oppose the proposed rule and respectfully request that the proposed rule be amended to provide that it applies only to investment adviser representatives of state-registered advisers.[4]

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[3] Memorandum dated May 16, 1996 from the Division of Investment Management to the Senate Securities Committee Staff, File Docket NO. F7-98 (emphasis added). Indeed, the Division of Investment Management had recommended including the provision permitting state enforcement actions for fraud and deceit, because it believed that NSMIA would have preempted such authority unless specifically preserved.

[4] As discussed in our letter to the Department dated January 14, 1998, we also strongly object to Tennessee's rules regarding custody, financial and disciplinary disclosure, advertising, cash solicitation, and agency cross transaction, which apply to all investment advisers, rather than solely investment advisers that are state-registered. For the same reasons, these rules are directly contrary to NSMIA and should be amended to reflect that they apply only to state-registered advisers. *See* Letter to Daphne D. Smith, Assistant Commissioner for Securities from Karen L. Barr, ICAA General Counsel (January 14, 1998).

5. **Proposed Rule 0780-4-3.06 - Investment Adviser Notice Filings.** The proposed rule provides that all material changes in a federal covered adviser's notice filing should be set forth in an amendment to Form ADV and filed promptly with the Division through the IARD. This process is automatic with the IARD system. Under NSMIA, however, only the SEC may prescribe when amendments should be filed. States are only permitted to request copies of the documents filed with the SEC. Accordingly, we suggest deleting this paragraph in its entirety and replacing it with: "Investment adviser notice filers shall submit their amendments pursuant to Securities and Exchange Commission requirements."

We also take this opportunity to urge you to consider adoption of the Uniform Act in your state. The Uniform Act is the result of years of careful deliberation and drafting that involved input from a broad range of regulatory bodies and securities market participants. This important piece of legislation would allow you to conform your securities laws to the laws of other states, while modernizing your statute to conform with recent changes in federal securities laws.

We truly appreciate your consideration of our comments. We would be pleased to discuss any of these issues with you at your convenience. Please do not hesitate to contact me or Karen Barr, ICAA General Counsel, with any questions or concerns.

Sincerely,

Rasha Elganzouri
ICAA Counsel

ICAA

August 19, 2003

Mr. Richard B. Smith
Chairman
Uniform Securities Act Drafting Committee
David Polk & Wardwell
450 Lexington Avenue
New York, NY 10017

Dear Mr. Smith:

The Investment Counsel Association of America (ICAA) appreciates the opportunity to endorse the Uniform Securities Act of 2002 (Act).[1] The final statute is the result of four years of careful deliberation and drafting that involved input from a broad range of regulatory bodies and securities market participants.

The ICAA worked closely with the National Conference of Commissioners on Uniform State Laws, the North American Securities Administrators Association, and other industry advisory groups during the drafting process, and strongly supports the Act. This important statute enables states to modernize their securities laws to address changes in the securities industry and in federal securities laws. In addition, the Act provides important investor protection tools for state regulators and promotes efficient coordination of federal and state securities regulation. Significantly, the Act promotes uniformity of state securities laws, consistent with the National Securities Markets Improvement Act of 1996.

We look forward to working with you to achieve adoption of the Act in all states. Please do not hesitate to contact us if we may be of any assistance to you.

Sincerely,

Karen L. Barr
General Counsel

[1] The ICAA is a not-for-profit organization that exclusively represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA today consists of about 300 federally registered investment advisory firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. Virtually all ICAA member firms have a multi-state or national business. The ICAA has been an active and consistent supporter of uniformity in the treatment of SEC-registered advisers by the various states and regulators.

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ICAA

August 28, 2003

By Facsimile and U.S. Mail

Vincent L. Usera
Senior Securities Examiner
Division of Banking, Securities and Corporations
Department of Community and Economic Development
P.O. Box 110807
Juneau, AK 99811-0807

Re: Proposed Changes to the Regulations in Title 3 of the Alaska Administrative Code Dealing with Securities

Dear Mr. Usera:

The Investment Counsel Association of America[1] appreciates the opportunity to comment on the Department of Community and Economic Development's proposed changes in regulations dealing with securities, as set forth in Title 3 of the Alaska Administrative Code. The proposed changes, among other provisions, would increase the notice filing fees for federally registered investment advisers. The ICAA opposes the fee increase for the following reasons.

Proposed Rule 3 AAC 08.015(a) would increase initial and annual notice filing fees for federally registered investment advisers from $250 to $350. The proposed fee increase does not apply to state registered investment advisers. We believe that the filing fee increase is discriminatory and detrimental to interstate commerce because it imposes higher filing fees for principally out-of-state advisers that notice file in Alaska as compared to state-registered investment advisers.[2]

In addition, the difference in fees has an inverse relationship to the responsibilities of the Division in regulating the two categories of advisers. Since enactment of the

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[1] The Investment Counsel Association of America, Inc. is a not-for-profit organization that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA's membership today consists of about 300 federally registered advisory firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. For more information about the Association, please see our web site at www.icaa.org.

[2] Federally registered advisers are generally advisers with a multi-state or national business. We understand that most notice filers in Alaska are not headquartered in Alaska. State-registered advisers in Alaska generally are local businesses, with their principal place of business in Alaska.

National Securities Markets Improvement Act of 1996 (NSMIA), when regulatory responsibilities for investment advisers were divided between the U.S. Securities and Exchange Commission (SEC) and the states, states have had full regulatory authority and responsibility over state-registered investment advisers and the SEC has full responsibility for federal covered advisers. State authority over federally registered investment advisers is limited to receiving notice copies of documents federal covered advisers file with the SEC, requiring fees for such notices, and bringing enforcement actions for fraud and deceit. With the implementation of the IARD system, the state does not even have to process any paperwork – all notices from federal covered advisers are received electronically. The state does not have any obligation even to review the filings. Accordingly, there is no regulatory justification for the disparity in fees.

Moreover, the Division has proffered no budgetary reason for the fee disparity or even any increase for that matter. We understand that the revenues collected by the Division from participants in the securities markets far exceed the Division's budget for regulation of such entities.

Finally, we believe that the higher filing fee is unfair to investors in your state because the higher fee may deter federal covered advisers from offering investment advisory services to Alaska residents. This could lead to less competition for investment advisers and fewer investment adviser choices for investors in your state.

We appreciate the opportunity to comment on the proposed regulations. Please do not hesitate to call me if you have any questions or concerns.

Sincerely,

Karen L. Barr
General Counsel

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ICAA

October 9, 2003

Via Electronic Mail

Ashley Kovas
Business Standards Department
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Mr. Kovas:

The Investment Counsel Association of America (ICAA) greatly appreciates the opportunity to comment on the Financial Services Authority's Consultation Paper 176 (CP 176) entitled Bundled Brokerage and Soft Commission Arrangements (April 2003).

The ICAA is a not-for-profit organization that represents the interests of investment advisers registered with the U.S. Securities and Exchange Commission. Our members collectively manage more than $3 trillion in assets worldwide for a wide variety of institutional and individual clients, including pension funds, trusts, investment companies, endowments, foundations, and corporations. Although the ICAA is a U.S.-based association, many of our members conduct substantial investment advisory business in the United Kingdom, primarily through UK affiliates that are registered with the FSA, and provide investment management services to UK clients.[1]

In CP 176, the FSA raises a number of concerns regarding bundled brokerage and soft commissions, including the lack of transparency of such arrangements, the potential for over-consumption of non-execution services, the potential for excessive trading, and the potential incentive for managers to select brokers based on softed services rather than quality of execution. To address these concerns, the FSA proposes two principal regulatory measures: (1) limiting the goods and services, beyond trade execution, that can be purchased with commissions; and (2) prohibiting managers from receiving bundled or softed services paid for with client commissions by mandating that the costs of non-execution services be rebated back to clients.

We write to express several concerns regarding CP 176. For the reasons stated below, we do not support the proposal to prohibit managers from passing on the costs of bundled services to clients. We also disagree with some of the principal assumptions

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[1] Founded in 1937, the ICAA today consists of more than 300 U.S. registered investment advisory firms. For more information about the Association, including a membership directory, please see our Web site at www.icaa.org.

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underlying the FSA's concerns regarding bundled and soft commission arrangements. We believe that the proposed changes to the FSA regulatory regime will be quite costly and burdensome to implement, particularly for global firms. Finally, the proposal raises significant cross-border issues that CP 176 did not address.

I. The Prohibition Of Cost Pass-Throughs Is Not the Optimal Approach

CP 176 proposes to deliver "greater transparency and accountability in the use of commission to purchase" services in addition to execution by prohibiting advisers from receiving bundled or softed services without rebating the cost of those services back to clients.[2] We certainly agree that transparency and accountability are worthy aims. However, these goals are best achieved by way of clear and complete disclosure to the parties involved. As a general matter, once material information is disclosed, market forces can then determine the consequences. Indeed, for this reason, most recognized securities regulatory regimes are structured around disclosure principles. Instead of contemplating a disclosure framework, however, CP 176 proposes to regulate cost pass-throughs of bundled and softed services directly, and indeed prohibit them. We do not believe this is the best approach to address these practices. We respectfully submit that, as long as material information is fully disclosed to clients, they and their managers should be permitted to negotiate how costs and fees are arranged and borne.

The proposal implies that commissions charged for transactions may be excessive or improperly structured. Given this concern, we are not convinced that regulating the consumers or end-users of these brokerage services – the managers and their clients is the optimal way to address such issues. If, as a matter of policy, the FSA does not believe brokers should bundle commissions with other services or believes commissions are excessive, the FSA should take the more direct approach of studying brokerage practices and determining whether to impose regulation on brokers regarding such practices. Indeed, absent further investigation and study, the impact of the FSA's proposal on commission costs is far from clear. The proposal that managers should separate out the components of commission charges may result in brokers eliminating additional services and keeping commissions at the same level – a result that would be detrimental to both investors and managers.

II. The Proposal Is Not Based on Adequate Evidence

CP 176 recommends significant regulatory changes based on several premises that are not supported by compelling evidence. Most importantly, the FSA expresses concern that soft commission and bundled brokerage arrangements create incentives for asset managers to over-consume non-execution products and services and to over-deal, or trade, excessively. The FSA therefore concludes that the incentives of portfolio managers are misaligned with those of their clients. We respectfully disagree with this conclusion.

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[2] CP 176, 4.13 at p. 26.

The key incentive and job performance measurement for portfolio managers – who actually make the decisions to buy or sell securities for clients – is the composite performance of their accounts. Performance results are calculated by deducting trading expenses. Thus, portfolio managers inherently are incented to keep costs as low as possible, aligning their interests with those of their clients. The Oxera Report acknowledges these aligned interests and specifically notes that client monitoring of fund performance implicitly includes monitoring of commission costs.

In addition, the investment adviser firm generally is compensated based on its assets under management. Therefore, the adviser has an inherent incentive to maximize total client assets and keep deductions from client assets (*e.g.* trading and other costs) as low as possible consistent with meeting the client's goals and guidelines.

The proposal briefly considers whether these aligned incentives are "sufficient" to address its concerns, but concludes that "if customers cannot easily observe the true price of fund management in total, they will not be able to determine rationally whether they should switch supplier." CP 176 at 18. This conclusion, however, completely disregards the fact that customers can indeed compare suppliers on an apples-to-apples basis, using performance results that account for trading expenses.[3]

Oxera does not make a finding that managers have traded excessively or that clients have paid too much in commissions. Instead, the FSA's concerns appear to be based solely on the proposition that the Oxera "findings *do not preclude* the *possibility* that bundling and softing *may* contribute to overtrading." We believe this hypothesis is not an appropriate basis for a significant regulatory change.

III. The Proposal Would Be Difficult and Burdensome for Managers to Implement

The FSA's proposal to rebate costs, particularly with respect to bundled brokerage, would be difficult and burdensome to implement. The proposal would require managers to value the component services they receive from broker-dealers as part of a single package for an agreed commission. Advisers would then be required to rebate to clients the costs of non-execution services that were "purchased" with the commission.

It would be extremely difficult for advisers to place a value on various types of brokerage research, access to analysts, advice regarding trade execution, and other bundled services. Indeed the Oxera report concurs that it "would be very difficult to unbundle [access to analysts] from trade execution." Oxera Report at 50. In-house research and services have not been previously valued separately, either generically or on

[3] Oxera states that the order of magnitude of commission costs "is relatively small" and that pension funds do not consider commission costs an important reason to switch fund managers. "The most important indicator that is monitored by pension funds is performance." Oxera Report at 58. Instead of drawing the appropriate conclusion that pension funds can choose for themselves how and what to monitor, the proposal appears to conclude that funds should switch managers based on commission costs.

a firm-by-firm or industry-by-industry basis. Similarly, we are not aware of any evidence that bundled services provided by brokerage houses may be valued appropriately by comparing them to services offered by independent vendors.

There is no regulatory requirement for brokers to provide separate invoices for various components of the services they provide. We strongly believe that it is highly unlikely that advisers will be able successfully to pressure brokers to provide such information. The proposal apparently contemplates that advisers simply will be able to determine execution-only costs and deduct the remainder. However, this calculation is problematic as well. For example, an adviser would not be able to use the bare minimum commission charged by a discount or on-line broker for large block trades not adequately executed in that medium. Another example is execution of debt transactions; there is no standard method to determine the costs of fixed-income executions.

In addition, determining the "execution-only price" does not account for concepts of "best execution," *i.e.*, the quality of execution in addition to commission cost. A manager should be able to consider factors in addition to the lowest available commission rate to determine the "pure" execution cost of a trade. Factors may include the size of transaction, the timeliness of execution, the ability of the broker to commit capital, the ability to maintain the investor's anonymity, or the ability of the broker to handle difficult trades or unusual market conditions.[4] Different types of trades would have to be evaluated on a case-by-case basis, which would be very difficult operationally. Even if feasible, the internal compliance and back-office costs of determining and auditing the various values of components of bundled brokerage would be quite substantial.

Moreover, because execution is difficult to quantify, the resulting allocation between execution and non-execution portions of transaction costs necessarily will be at best subjective and at worst arbitrary. Different advisers will undoubtedly make different good faith estimates of costs, based on the relative value of the services provided regarding any particular transaction. Accordingly, even good faith attempts at calculating the refund or rebate due to clients could result in unwarranted exposure to liability for investment advisers.

CP 176 implies that investment advisers are intentionally purchasing each and every component of the bundle each time they execute a trade. Our experience indicates that advisers generally select brokers based on an ongoing course of dealing and the quality and strength of the broker in various areas. For example, an adviser may select a particular broker for its expertise in certain transactions and receive unsolicited research from the broker, as well as beneficial execution advice and access to analysts. The adviser is still achieving best execution and best overall cost for the client. Under the FSA proposal, the adviser would have to place some value on unsolicited research and rebate this amount to the client, even though the adviser has selected the best broker for

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[4] *See, e.g.,* Association of Investment Management and Research, Trade Management Guidelines (available at: http://www.aimr.com/pdf/standards/trademgmt_guidelines.pdf); CP 154: Best Execution, Financial Services Authority (October 2002).

the transaction and has not benefited from the research. Ironically, the proposal may actually create a disincentive for advisers to select the brokerage firm that provides the highest quality executions for certain types of transactions.

IV. The Proposal Would Impose Substantial Costs on Investment Advisers That May Not Be Recovered

The FSA acknowledges that its proposal would impose costs on investment managers. Nevertheless, the FSA appears to assume that asset managers will be able to recapture the increased costs of the new rules by increasing management fees. This probability is remote, considering the highly competitive nature of the asset management business and the negative market conditions over the past three years. In all likelihood, buy-side margins would decrease, with a particularly acute impact on small and mid-size advisers, who are heavier users of soft commissions and bundled brokerage and who have fewer in-house resources to devote to internal research.

V. The Proposal Raises Serious Cross-Border Issues

CP 176 appears to assume that UK managers advise only UK clients and execute trades only in the UK. It does not fully discuss any global market implications of the proposal. However, we believe the proposal will have significant implications for international businesses and international trading.

We understand that the proposal would apply only to advisers that are formally authorised by the FSA. These advisers, however, apparently would be subject to the rules for trading conducted both through UK and non-UK broker-dealers. UK advisers may have offices, clients, affiliates, and trading desks worldwide. For example, we understand that many FSA-authorised managers conduct trades of non-UK securities through non-UK brokers. As a result, the proposal would indirectly impose a new trading regime on broker-dealers globally. There has been no study of how non-UK brokers might react to pressure to unbundle their services or to refrain from providing soft commission credits for certain types of services, or whether different rates might be charged to UK investment managers.

In addition, the proposal would have significant implications for investment managers with multi-national businesses. Global advisers use a wide range of business structures. For example, a number of asset managers have global trading desks, including in London, which handle trades for all of the firms' clients. The new rules presumably would apply to all trading from a firm's London desk, whether or not the desk is servicing UK clients. An adviser principally based in the U.S. may have a UK office or affiliate that services UK and other clients either worldwide or in Europe. That affiliate may handle only business development and client servicing; it may or may not have a trading desk that services UK and other clients; it may or may not handle the actual investment management for UK or European clients.

It is not clear how CP 176 would apply under the various permutations and business structures outlined above. For example, some U.S.-based advisers have a UK affiliate registered with the FSA that handles only business development and client servicing for clients in the region. The UK clients contract with the UK affiliate, which engages the U.S. adviser for investment management, with a trading desk in the U.S. When the U.S. trading desk conducts block trades, how will it deal with varying regulations pertaining to UK clients? The firm would have to decide whether to trade for UK clients separately or use FSA rules for all trades. UK clients that are precluded from opportunities to participate in block transactions may indeed see their transaction costs rise. To apply the FSA rules only to UK clients, the advisory firm could only instruct brokers not to apply commissions for trades for certain accounts to the adviser's soft dollar credits. This arrangement, however, would not result in any change to the client's commission cost for the trade and would simply provide greater profitability for the broker.

Other advisers have affiliates with a London trading desk that executes trades for certain segments of the markets for clients worldwide. It not clear whether the London trading desk would be required to apply UK softing and bundled brokerage rules to all clients internationally. With respect to rebates of the value of non-execution services, it seems unlikely that an adviser realistically would be able to make such payments to UK clients, but not to other clients of the same affiliate or using the same trading desk.

These uncertainties could lead to unfortunate results. For example, some international firms could choose to conduct their European business from an office or affiliate in a non-UK jurisdiction. Similarly, some firms could maintain their UK office solely for UK clients and UK trading and divert their other international business elsewhere. The proposed rule would serve as a strong incentive for firms to cease using their UK subsidiaries as the counterparty for non-UK clients and to move their trading desks out of London. This would result in a significant competitive disadvantage for both UK advisers and brokers.

The simplest and most rational way of addressing these issues would be to follow the internationally recognized route of a regulatory disclosure framework. Disclosure would not have a similar effect on investment advisory firms and would maintain the competitive status quo. At the same time, increased disclosure and monitoring of trade execution would benefit investors.

Should the FSA nevertheless determine to proceed with its proposal, we respectfully request that the rules apply only to those clients of FSA-registered advisers that are resident in or principally based in the UK. This may reduce the likelihood that FSA-registered firms direct their non-UK clients to other offices or affiliates. Limiting the proposal to UK clients may also assist in reducing the costs of the proposal, though many substantial challenges would remain.

At a minimum, we strongly urge the FSA to engage in a dialogue with other international regulators, including the U.S. SEC and European regulators, to harmonize rules and regulations affecting international asset managers with respect to soft commissions and bundled brokerage.

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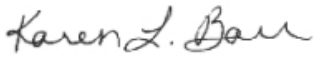
We truly appreciate your consideration of our comments on CP 176. Please do not hesitate to contact us if we may provide additional information or assistance to you regarding these issues.

Sincerely,



Karen L. Barr
General Counsel

cc: Chairman William H. Donaldson
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
U.S. Securities and Exchange Commission

Paul F. Roye, Director
Robert E. Plaze, Associate Director
Division of Investment Management
U.S. Securities and Exchange Commission

ICAA

October 20, 2003

Via Electronic Delivery

Ms. Karen E. Lloyd
U.S. Department of Labor
Office of Exemption Determinations
Employee Benefits Security Administration
Room N-5649
200 Constitution Avenue, N.W.
Washington, DC 20210

Re: PTE 84-14 Amendment

Dear Ms. Lloyd:

The Investment Counsel Association of America[1] appreciates the opportunity to comment on the amendments proposed by the U.S. Department of Labor to Prohibited Transaction Class Exemption 84-14, which applies to transactions negotiated by a qualified professional asset manager (QPAM Exemption).[2] As managers of employee benefit and pension plan assets, many of our members are subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA) and rely on the QPAM Exemption. The ICAA generally supports the liberalization of the QPAM Exemption as responsive to challenges posed by the recent consolidation of the financial services industry. As discussed below, we do have certain concerns about the Proposal's "independence" requirement.

The QPAM Exemption allows a fund managed by a QPAM to engage in all transactions described in Section 406(a)(1)(A)-(D) of ERISA with virtually all parties in

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1 The ICAA is a not-for-profit association that represents the interests of the registered investment advisory profession. Founded in 1937, the ICAA's membership today consists of more than 300 SEC-registered investment advisory firms that collectively manage in excess of $3 trillion for a wide variety of institutional and individual clients. See www.icaa.org for more information.

2 68 F.R. 52419 (2003)(Proposal).

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interest provided certain conditions are met. The exemption consists of five parts: (1) the general exemption; (2) specific exemptions for employers; (3) a specific lease exemption for QPAMS; (4) transactions involving places of public accommodations; and (5) definitions and rules. The Proposal would modify the general exemption and certain definitional terms in several important respects.

The Proposal would ease several important aspects of the general exemption, which permits transactions between parties in interest with respect to an employee benefit plan and an investment fund in which the plan has an interest provided the plan is managed by a QPAM and certain conditions are satisfied. Part I(a) of the general exemption provides that the party in interest or its affiliate must not currently have, nor have exercised during the immediately preceding year, the authority to appoint or terminate the QPAM or to negotiate the terms of the management agreement with the QPAM on behalf of the plan. The Proposal would eliminate the one-year look back rule and clarify that the power-of-appointment rule applies only to the particular assets involved in the transaction. We strongly support this aspect of the Proposal. A new rule would also permit QPAMs managing collective investment funds to deal, on behalf of the fund, with persons who are, or are affiliated with, parties in interest with authority to invest or redeem a plan's interest in the investment fund, provided that the plan's interest in the fund represents less than 10 percent of the investment fund's total assets.

The Proposal would narrow the definitions of "affiliate" and "related" person. An "affiliate" would include only highly compensated employees and partnerships holding a 10-percent or greater interest (currently 5 percent). The 5-percent interest in an entity that currently triggers the related-person test would be altered under the Proposal so that a QPAM would be related to a party in interest only if: (i) the QPAM or the party in interest owns 10 percent or more of the other entity; (ii) a person controlling or controlled by the QPAM or the party in interest owns a 20-percent or more interest in the other entity; or (iii) a person controlling or controlled by the QPAM or party in interest owns less than 20 percent interest in the other entity but nevertheless exercises control over the management or policies of the other party by reason of its ownership interest. The Proposal would also clarify that a related party determination may be made as of the last day of the most recent calendar quarter.

The ICAA strongly supports the proposed enhancements to the general exemption and the modifications to the "affiliate" and "related" person terms. We believe that the Labor Department has struck the right balance between ensuring appropriate investor protection and meeting the challenges of a consolidating and evolving industry.

However, we have substantial reservations about the proposed "independence" requirement. The Proposal would add a new condition to the definition of QPAM by specifically requiring that a QPAM must be independent of the employer sponsoring the plan whose assets are managed by the QPAM. In this respect, Section I(a) of the QPAM Exemption, which already precludes a QPAM from relying on the exemption with respect to a transaction involving itself or a person to which it is related, has never been understood, to prevent a QPAM from relying on the exemption with respect to a

transaction between a plan and a service provider unrelated to the QPAM. We are concerned that the independence requirement in the definition proposed in the amendment will jeopardize reliance on the QPAM exemption by investment advisers that manage their own and their affiliates' "in-house" employee benefit plans, including in-house assets invested in pooled fund arrangements. Investment managers who have previously been acknowledged by the Department as appropriate providers of financial management services to such in-house plans might now be compelled to establish relationships with third-party managers to the extent another exemption is not available.[3]

The Department has not provided a compelling rationale for prohibiting a fiduciary from serving as a QPAM for its own plan. The proposal simply cites to the preamble of the QPAM Exemption that the exemption is available "only if the commitments and the investments of the plan assets and the negotiations leading thereto, are the sole responsibility of an independent investment manager." The focus of the QPAM exemption, however, is on (i) independence of the manager *from the service provider*; and (ii) sufficient independence from persons with authority to appoint and remove the QPAM in order to avoid the possibility of undue influence. We believe that neither of these concerns is at issue when a QPAM is acting with respect to its own plan. In fact, the Department does not appear to have made a determination that the independence of the manager *from the employer* has been a problem in those cases where the fiduciary is not a classic in-house manager and a substantial portion of the fiduciary's business is managing the assets of third parties.

Importantly, many managers that would qualify as a QPAM, but for the proposed independence requirement, would be unable to rely on Prohibited Transaction Class Exemption 96-23, which permits certain transactions involving employee benefit plans the assets of which are managed by in-house managers (INHAM Exemption). The INHAM Exemption was prompted by a desire to cover large employers engaged in businesses other than investment management (for example, automobile manufacturers) that have the capabilities within their organization to manage plan assets. From an investment adviser's perspective, there are several significant impediments to reliance on the INHAM Exemption. First, the INHAM Exemption may be construed to be available only to an entity that manages assets of plans maintained by *affiliates* of the INHAM in excess of $50 million. If an investment manager is managing the assets of its own plan, the INHAM Exemption may not be available. Second, the INHAM Exemption is available only to subsidiaries that are wholly-owned, directly or indirectly, by an employer or the parent of that employer. Many of our members are not wholly owned subsidiaries of a parent for which they manage plan assets. Third, an INHAM must have under its management $50 million or more in assets attributable to plans maintained by its affiliates; and plans maintained by affiliates of the INHAM and/or the INHAM must have aggregate assets of $250 million or more. Many investment advisers, even large and well-established ones, do not have plans of this size. Finally, the costs associated

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[3] *See*, e.g., Prohibited Transaction Exemption 77-3, which provides relief for the acquisition or sale of shares of a registered open-end investment company by an in-house employee benefit plan.

with complying with the INHAM Exemption would present significant new costs to investment advisers that would otherwise qualify as QPAMs.

For these reasons, we urge the Department of Labor to revise the proposed independence requirement of the Proposal to clarify that an investment adviser may act as a QPAM for its own employee plan or the plan of its affiliates. We would be pleased to meet with the Department to discuss other appropriate alternatives to this particular aspect of the Proposal.

Finally, the Proposal would increase the financial thresholds in the QPAM definition to require that a QPAM hold more than $85 million in client assets under management (currently $50 million), and shareholders' or partners' equity in excess of $1 million (currently $750,000). The Proposal would further clarify that the assets under management be determined as of the last day of the adviser's most recent fiscal year. We ask the Department to clarify that the financial thresholds would be applicable only for fiscal years beginning after the final amended exemption is published in the Federal Register. Further, while we understand the necessity of adjusting financial thresholds to reflect changes in the Consumer Price Index, we note that this aspect of the Proposal will result in many fewer investment advisers being able to act as QPAMs.[4]

Please do not hesitate to contact the undersigned or Caroline Schaefer, Associate General Counsel if you have questions or require additional information related to this submission.

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Sincerely,

KAREN L. BARR
General Counsel

[4] According to data collected by the SEC, more than 1,000 registered investment advisers manage more than $50 million but less than $85 million in total assets. Data indicate that more than 600 of those advisers manage some type of pension or profit sharing plan.