ICAA

January 27, 2004

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

Re: Model Code of Ethics for Investment Advisers

Dear Chairman Donaldson:

The Investment Counsel Association of America[1] is pleased to inform the Commission that we intend to develop a model code of ethics for investment advisers.

On January 14, the Commission unanimously approved for comment a proposed rule[2] under the Investment Advisers Act of 1940 that would require registered investment advisers to adopt written codes of ethics. Under the proposed rule, the codes of ethics would set forth standards of conduct expected of advisory personnel, safeguard material nonpublic information about client transactions, and address conflicts of interest that arise from personal trading by advisory personnel.

The ICAA strongly supports the fundamental requirement that all registered investment advisers should adopt and implement written codes of ethics. As the proposing release indicates,[3] the ICAA previously has endorsed the concept that all investment advisers should develop and follow written codes of ethics that contain appropriate restrictions on personal trading, insider trading, and relationships with brokers, vendors, and other third parties.[4] In fact, since the founding of the ICAA in 1937, our organization has endorsed standards and principles that have emphasized an

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1 The ICAA is the not-for-profit association that represents the interests of the investment advisory profession. Founded in 1937, our membership today consists of more than 300 federally registered investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional investors. For more information, please visit: www.icaa.org.

2 *Investment Adviser Codes of Ethics*, Release Nos. IA-2209, IC-26337; File No. S7-04-04 (January 20, 2004).

3 *Supra,* footnote 55.

4 *Investment Counsel Association of America, Inc. Guidelines on Personal Investing* (February 15, 1995).

INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.
1050 17TH STREET, N.W., SUITE 725 WASHINGTON, DC 20036-5503
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investment adviser's fiduciary duty. The Commission's proposed code of ethics requirement certainly is consistent with this bedrock duty.[5]

We submit that the development of a model code of ethics – covering both fund and non-fund investment advisers – will serve a number of salutary purposes. Certainly, such guidelines will help to assist investment advisory firms in complying with the Commission's new regulations. We believe our effort also will help to promote practices by the investment advisory profession that go beyond mere strict adherence to the "black letter" rule of law and thus will bolster efforts to enhance investor protection. Finally, we believe the investment advisory profession can serve an important role in continuing to emphasize an investment adviser's fiduciary duty and thereby help stem abuses that have been identified. We strongly agree with statements by you and other Commissioners that no single "silver bullet" exists to cure all problems and that multiple and varied approaches – including industry initiatives – are needed to restore trust in our markets and to promote compliance with laws and regulations governing investment advisers. Accordingly, our intent in developing a model code of ethics is to recommend approaches to an adviser's fiduciary role that are complementary – and supplementary – to the Commission's proposed rule.

As you know, our diverse membership reflects a broad range of investment advisory firms (including small, mid-sized, and larger firms), a wide variety of business models and investment styles, and an extremely varied clientele (including individuals, public and private pension plans, trusts, foundations and endowments, and pooled investment vehicles such as mutual funds and hedge funds). Accordingly, the ICAA is uniquely positioned to address many of the issues involved in developing guidelines for codes of ethics for all types of investment advisory firms. Regardless of the enormous variation among investment advisory firms, we strongly believe that overriding fiduciary and ethical principles serve as a common denominator that transcend differences among various investment advisory firms.

In issuing the proposed rule, you made the following statements:

> "As fiduciaries, advisers owe their clients *more* than mere honesty and good faith. What we are seeing leads me to believe that all too many advisers have been delivering much less. Today's proposals will reinforce for investment advisers and their employees the importance of fiduciary principles as the cornerstone of their relationships with advisory clients."

The ICAA hopes that our efforts in developing a model code of ethics for investment advisers will assist the Commission to achieve these laudable goals by encouraging the investment advisory profession to renew its commitment to fiduciary standards.

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[5] *See, ICAA Standards of Practice.* The ICAA's principles of conduct were originally set forth in its Code of Professional Conduct in 1937 and later in its statement of Function and Principles. Over the years, many of these principles have been used by Congress and the Commission as the basis for legislation and regulations governing the conduct of investment advisers and by the U.S. Supreme Court in defining the standards of fiduciary conduct applicable to all investment advisers.

We look forward to working closely with the Commission on these and other matters and trust that you will not hesitate to contact us if we may provide any additional information.

Sincerely,

David G Tittsworth

DAVID G. TITTSWORTH
Executive Director

Cc: The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
Paul F. 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 Board of Governors

ICAA

February 3, 2004

Via Electronic Filing

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

Re: Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204, IC-26299; File No. S7-03-03

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments to the Commission on certain provisions of new Rule 38a-1 under the Investment Company Act of 1940 (fund compliance rule), which was adopted on December 3, 2003 together with Rule 206(4)-7 under the Investment Advisers Act of 1940 (adviser compliance rule).[2] These rules require investment companies and investment advisers registered with the Commission to adopt formal compliance programs. Specifically, the rules require investment advisers and investment companies to: (1) adopt and implement written policies and procedures designed to prevent violations of the federal securities laws; (2) conduct an annual review of such policies and procedures; and (3) designate a chief compliance officer (CCO) responsible for administering the policies and procedures.

The Commission included in the adoption of the fund compliance rule certain changes from the proposed rule that are designed to enhance the independence of the fund's CCO, including: (1) a requirement that the fund's board approve the fund CCO's designation and compensation (and any changes to the CCO's compensation); (2) granting the fund board sole power to remove the CCO from his or her position; (3) a requirement that the fund CCO report directly to the board and meet with the independent directors in executive session at least annually; and (4) a prohibition against coercing or fraudulently influencing the CCO in

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2 *Final Rule: Compliance Programs for Investment Companies and Investment Advisers*, SEC Release Nos. IA-2204; IC-26299; File No. S7-03-03 (Dec. 17, 2003).

the course of his or her responsibilities. Although the rule is final, the Commission requested comment on these provisions because they were not included in the proposal.[3]

The ICAA has consistently promoted the use of strong compliance systems as a best practice for investment advisers and therefore generally supported the proposed adviser compliance rule.[4] The ICAA specifically supported the requirement to designate a CCO and strongly supported a requirement that the CCO either be a member of senior management or directly report to senior management to ensure that CCOs have sufficient authority to implement their compliance programs. We therefore applaud the Commission's statement in the adopting release that an adviser's chief compliance officer should be "empowered with full responsibility and authority to develop policies and procedures for the firm…and should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures."[5] We have significant concerns, however, regarding two elements of the final fund rule with respect to fund CCOs.

First, we do not agree that the fund board should be responsible for approving the fund CCO's compensation package or changes to that compensation package. Second, we do not agree that the fund board should have the sole power to remove the fund CCO from his or her position. While we understand the Commission's goal of enhancing compliance by facilitating interaction between the independent directors and the fund CCO, we believe these proposed aspects of the rule constitute an unwarranted regulatory intrusion into the business affairs of the investment adviser. Compensation issues and employment decisions are internal human resources issues and should not be the subject of command-and-control regulatory mandates. Further, eliminating these two aspects of the rule will not reduce its effectiveness in any manner because the independent directors retain full authority to make inquiries and to receive and evaluate information that may be relevant to the interests of the fund shareholders (such as actions taken by the adviser with respect to the fund CCO). Moreover, if the board is dissatisfied with any of the adviser's actions, it retains the ultimate leverage by virtue of its contract with the adviser.

While it may be appropriate for the fund board to approve the adviser's designation of the fund CCO, it is inappropriate to task the fund board with the approval of the fund CCO compensation package and any changes to that compensation package. This is an operational activity that logically falls within the responsibilities of the advisory firm as the employer of the fund CCO. Advisers, as operating businesses, have budgets, compensation pressures, and equity/ownership issues to address on an ongoing basis. A fund board demand to increase CCO compensation may create inequities within the adviser's compensation structure that have implications for all advisory employees. Significantly, there are no implications to the fund board in making compensation demands on behalf of the CCO because of the implicit expectation that increased compensation costs will be borne by the adviser. Further, the board presumably will be required to engage in the impractical task of compensation analysis among

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3 *Proposed Rule: Compliance Programs for Investment Companies and Investment Advisers*, SEC Release Nos. IC-25925, IA-2107, File No. S7-03-03 (Feb. 5, 2003).

4 *See* Letter from David G. Tittsworth, Executive Director, ICAA, to Jonathan G. Katz, Secretary, SEC (Apr. 17, 2003).

5 *See* note 2, *supra*, at 10.

advisers of similar size and type, taking into consideration all of the adviser's clients, not merely fund clients, and varying CCO responsibilities among firms.

Similarly, the fund board should not have sole power to remove an employee of the investment adviser. This puts the adviser in the untenable position of having an employee who has little or no accountability to the adviser. There are many perfectly legitimate business reasons that an adviser's termination of an employee CCO may be appropriate, including reasons related to the employee's non-fund duties. Because the board does not have day-to-day contact with the CCO, the board will not be aware of potential issues of concern to the adviser, such as the CCO's work ethic, conduct with other advisory personnel, handling of matters related to non-fund clients, and internal team dynamics. The adviser should be permitted to terminate the employment of an employee who is a fund CCO, albeit with notice to the board. Providing the board notice of the adviser's intent to terminate the fund CCO would allow the members of the board to intervene or react in whatever manner they deem appropriate, while retaining the adviser's control over its own employees.

Permitting the adviser to control its own employment relationships is essential to maintaining an arms-length relationship between the adviser and the fund. The rule clearly contemplates that the fund CCO and the investment adviser's CCO may be the same person. In such cases, the fund CCO is not a fund employee, but an employee of the adviser, who most likely has duties and responsibilities for all of the adviser's clients, not just fund clients. As an advisory employee, a fund CCO fundamentally lacks "independence" from the adviser and inherently has the conflict posited by the Commission. The Commission's rule complicates the role of the CCO rather than clarifying it. Instead of attempting to make an advisory employee "independent" of the adviser, the Commission should encourage fund boards to require material information from the adviser regarding the CCO and the compliance program and to exercise active oversight. The fund board is responsible for overseeing the fund and protecting fund investors. It is the responsibility of the board and particularly the independent directors to evaluate information and make inquiries necessary to assure the protection of fund investors. Indeed, the Commission recently proposed several major rule amendments that are designed to increase investor protection by enhancing the independence of fund boards, including: (1) a requirement that funds have an independent chairman; (2) a requirement that 75 percent of each fund board be comprised of independent directors; (3) authorization for fund boards to retain staff; and (4) a requirement that boards annually evaluate their performance on shareholders' behalf.[6]

The other elements of the fund compliance rule fully empower the fund CCO in a meaningful and logical way. The rule requires the fund board to approve the designation of the fund CCO. The rule requires the fund CCO to meet directly with the fund board and to meet with the independent directors in private, executive session on at least an annual basis. Further, the fund rule prohibits the adviser or its employees from coercing or fraudulently influencing the fund CCO in the course of his or her responsibilities. These requirements will forge communication lines between the board and the CCO. They will also ensure that the CCO is empowered to share with the board any and all concerns related to compliance problems or issues at the management company or other fund service providers. These

6 *Proposed Rule: Investment Company Governance*, SEC Release No. IC-26323; File No. S7-03-04 (Jan. 15, 2004).

measures obviate the need for the board to perform human resources or operational activities that more appropriately fall within the responsibility of the investment adviser.

We commend the Commission's goal of enhancing compliance programs for investment advisers and investment companies and would be pleased to work with the Commission to implement these initiatives. We appreciate the opportunity to comment on the effects of the final fund compliance rule on investment advisers. Please do not hesitate to contact the undersigned or ICAA Associate General Counsel Caroline Schaefer to discuss any questions the Commission or its staff may have with respect to our comments.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

February 5, 2004

Mr. David G. Tittsworth
Executive Director
Investment Counsel Association of America, Inc.
1050 17th Street, N.W., Suite 725
Washington, DC 20036

Dear Mr. Tittsworth:

I was very pleased to receive your January 27th letter pledging to develop a model code of ethics for investment advisers. I commend you and the ICAA for your initiative in this critical area, and appreciate your response to the Commission's recent proposal to require that all registered investment advisers adopt and implement written codes of ethics.

As you are aware, it is critical that advisers, as fiduciaries, are honest, act in good faith and put their clients' interests above their own. The ICAA can play a crucial role in helping investment advisers adopt codes of ethics that not only meet, but exceed, this fundamental principal.

You are to be applauded for taking this important first step in ensuring that advisers have codes of ethics designed to protect the interests of their advisory clients. I look forward to reviewing the model codes and also encourage the ICAA to comment on the Commission's code of ethics proposal.

Thank you again for your leadership in this area.

Sincerely,

Bill Donaldson

William H. Donaldson

ICAA

FOR IMMEDIATE RELEASE
March 3, 2004

CONTACT: DAVID TITTSWORTH
202.293.4222

ICAA STATEMENT RE: SOFT DOLLARS

(Washington, D.C.) The Investment Counsel Association of America today issued the following statement regarding soft dollars:

The ICAA fully supports SEC Chairman Donaldson's announced initiative to analyze issues related to soft dollars and we stand ready to assist the Commission in this important effort. Specifically, we encourage the SEC to require enhanced disclosure of soft dollar practices to clients and to focus on whether the SEC's interpretation of allowable research requires clarification. However, the ICAA believes the SEC should reject the Investment Company Institute's proposal to eliminate all third-party research from soft dollar practices. We believe this aspect of ICI's proposal is fundamentally flawed. It would result in a diminution of quality research and thus is contrary to our strong support for independent research that benefits investors. If adopted, the proposal would unfairly advantage full-service brokerage firms and disadvantage third-party research providers, as well as clients of investment advisers who benefit from third-party research.

The ICAA has been a consistent advocate for high ethical standards and strong and effective compliance practices. The ICAA *Standards of Practice*, first adopted in 1937, continue to emphasize that an investment adviser is a fiduciary that has the responsibility to render professional, continuous, and unbiased investment advice to its clients. As such, basic fiduciary principles prohibit an investment adviser from taking an interest that is potentially adverse to its clients without the client's informed consent and from using client assets for its own benefit. Client brokerage is an asset that should be used in the best interests of the client. Accordingly, investment advisers that choose to enter into soft dollar arrangements must be mindful of their fiduciary obligations, including their duty to make full and complete disclosure to investors about such practices.

In 1975, the Securities and Exchange Commission acted to make the U.S. securities markets more competitive by abolishing fixed commission rates. Shortly thereafter, Congress enacted section 28(e) of the Securities Exchange Act of 1934, the safe harbor that allows investment advisers to "pay up" for research. Section 28(e) provides that a person who exercises investment discretion with respect to an account will not be deemed to have breached a fiduciary duty solely by reason of having caused the account to pay more than the lowest available commission, if such person determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided. Soft-dollar practices, as defined by the SEC, consist of arrangements in which products or services other than execution of securities transactions are obtained by an investment adviser by or through a broker-dealer as a result of the adviser's using the broker-dealer for execution of client securities transactions. The SEC's current definition of soft dollars makes no distinction between proprietary and third-party research and services.

The Investment Company Institute, a trade association that represents the mutual fund industry, wrote to SEC Chairman Donaldson in December proposing, among other things, that the SEC issue rules to exclude certain research products and services from the scope of section 28(e), including computer hardware and software, publications that are available to the general public, and all third-party research services. In January, Chairman Donaldson stated that he had directed the SEC staff to explore a number of complex issues, including "the use of soft-dollar arrangements by investment managers and the scope of the safe harbor contained in section 28(e) of the Exchange Act."

The ICAA fully supports Chairman Donaldson's initiative and stands ready to assist the Commission in analyzing current practices and identifying appropriate ways to improve soft dollar disclosure and to clarify current law. However, we believe the SEC should not eliminate all third-party research from the scope of the safe harbor.

As an initial matter, it is worth noting that the vast majority of investment advisory firms are small businesses that do not manage mutual funds. There are approximately 8,000 entities registered as investment advisers with the SEC. Of this total, more than 5,000 have 10 or fewer employees. More than 6,000 investment advisers report that they have no mutual fund clients. In fact, investment advisory firms have a wide variety of business models and investment styles and an extremely varied clientele, from individuals, families, and trusts, to a diverse range of institutional clients, including public and private pension plans, endowments, foundations, and pooled investment vehicles such as mutual funds and hedge funds. The ICAA's membership represents a cross-section of the broader universe of registered investment advisory firms.

Given the enormous diversity among the investment advisory profession and our membership, it should come as no surprise that there is not unanimous agreement on issues related to soft dollars. Some firms have expressed support for the concept of severely restricting – or even eliminating – soft dollar usage. In fact, some firms have voluntarily taken the position that they will not engage in soft dollar transactions, other than receiving research from full-service brokers. On the other hand, many firms have expressed a variety of serious concerns about the ICI's proposal. They particularly object to the proposal to eliminate the use of soft dollars for all third-party research, on the grounds that this will hurt clients and all investors because it will result in less innovative and independent research. Even among the minority of firms that view soft dollars as objectionable, most agree that the proposal to eliminate soft dollars for third-party research may have significant and unpredictable consequences.

We are persuaded that any proposal to eliminate soft dollars for third-party research, if adopted, would have unfortunate and untenable results. If adopted, it would have a number of profoundly negative consequences. It would result in an unjustifiable, unlevel playing field for many market participants. It would provide a regulatory-driven advantage for full-service brokerage firms and disadvantage third-party research providers. As such, it would increase costs for existing investment advisers and third-party research firms and would create an additional barrier to entry for new advisory and research firms. Most important, it would have adverse consequences for clients of investment advisory firms that benefit from third-party research. Instead of helping investors by giving investment advisers access to superior, independent research, the proposal in fact would reduce the overall research available, to the detriment of investors. Such a result would be particularly ironic in view of the problems that have been uncovered during the past few years relating to conflicted research provided by various brokerage firms. Indeed, many advisers believe that third-party research provided by independent firms is of higher quality than propriety research provided by large Wall Street brokerage firms. Further, using soft dollar credits for third-party research is undeniably more transparent than "paying up" for proprietary research from full-service brokers bundled with execution services. Third-party research is separately identified, invoiced, and quantifiable. Proprietary research is not. In this respect, the mutual fund industry's proposal would result in *less* transparency to market participants, regulators, clients, and investors.

In addition, we believe that eliminating third-party research will drive up costs for many investment advisory firms and may have undesirable economic consequences, particularly for smaller firms. Accordingly, the ICAA strongly urges the SEC to evaluate carefully the impact of such a proposal on investment advisers, including the thousands of smaller investment advisory firms. We also urge the SEC to study the potential impact of such a proposal on the quality and availability of research, a review that has never, to our knowledge, been undertaken. Due to the widespread use of soft dollars, we believe that any major change in their usage may have significant and unpredictable consequences – for investors, investment advisers, third-party research providers, and full-service brokerage firms. Given these potentially far-reaching implications, the SEC should take time to investigate the likely effects of any major changes in soft-dollar regulations.

Several years ago, the SEC's Office of Compliance, Inspections, and Examinations conducted an intensive fact-finding effort regarding current practices. OCIE's targeted examinations involved a large number of brokerage firms and investment advisers. In September 1998, OCIE issued an extensive written report detailing its findings. Among the most prominent findings were the following: (1) nearly all investment advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services; (2) by far, most of the products and services obtained by investment advisers with soft dollars fall within the definition of research, *i.e.,* they provide lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities; and (3) in cases where investment advisers received non-research products and services using soft dollar arrangements, virtually all investment advisers failed to provide meaningful disclosure of such practices to their clients (a practice that already violates current laws and regulations). A sound starting point for further SEC action would be to assess whether the conclusions from the prior report are still valid.

The ICAA believes that policy makers should ensure that there is adequate disclosure about soft dollar practices and then allow market forces to work in determining how and when such practices make sense. Investors deserve to have accurate and complete disclosure about soft dollar practices of brokerage firms and investment advisers so they can make a competent decision as to whether such practices are consistent with their interests. Ensuring appropriate disclosure in a competitive market will allow investors – rather than regulators – to make choices about soft dollar practices that work for them. As noted above, some investment advisory firms already have made the voluntary decision not to engage in soft dollar transactions involving third-party research providers. We believe that allowing market-driven decisions by investors, combined with full and complete disclosure, is certainly a better solution than abolishing soft dollar arrangements for third-party research services.

The ICAA also supports efforts by the SEC to clarify the types of products and services that constitute permissible research under current law. We recognize that research products and services are evolving, with innovative developments continuing on an ongoing basis. However, the SEC's clear guidance in this area, to the extent feasible, will have a salutary effect on both investment advisers' compliance programs, and the SEC staff's inspection of such programs.

The ICAA supports full and complete disclosure of potential conflicts of interest that confront investment advisers, including soft dollar arrangements. We look forward to working with the Congress, the SEC, and other policy makers to ensure that investors have full and complete disclosure of soft dollar practices and that uniform and consistent laws and regulations are in place governing these and related issues.

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ICAA

March 11, 2004

Via Electronic Filing

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

Re: Proposed Rule: Investment Adviser Code of Ethics, Release Nos. IA-2209, IC-26337; File No. S7-04-04

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments on proposed rule 204A-1 under the Investment Advisers Act of 1940 and related rule amendments.[2] The ICAA strongly supports the premise that every investment adviser should adopt a written code of ethics and we applaud the Commission for issuing this important proposal.

Proposed rule 204A-1 would require all investment advisers registered with the Commission to adopt codes of ethics that: (1) set forth standards of conduct expected of advisory personnel (including compliance with the federal securities laws); (2) safeguard material nonpublic information about client transactions; (3) require advisers' "access persons" to report their personal securities transactions, including transactions in any mutual fund managed by the adviser; (4) require advisers' access persons to obtain prior approval before investing in an initial public offering or private placement; (5) require prompt reporting to the adviser's chief compliance officer or other designated person of any violations of the code; and (6) require that each supervised person of the adviser acknowledge in writing receipt of a copy of the code and any amendments to the code.

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2 *Proposed Rule: Investment Adviser Codes of Ethics*, SEC Release Nos. IA-2209, IC-26337; File No. S7-04-04 (Jan. 20, 2004).

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I. The ICAA Supports the SEC's Code of Ethics Proposal

Since the founding of our organization in 1937, the ICAA has endorsed standards that emphasize an investment adviser's fiduciary duty and suggest principles of conduct that investment advisers should follow in the practice of their profession. Over the years, many of these principles have been used by Congress and the Commission as the basis for laws and regulations governing the conduct of investment advisers, and by the U.S. Supreme Court in defining the standards of fiduciary conduct applicable to all investment advisers. In addition, the ICAA has been a strong advocate of written codes of ethics. As noted in the proposal,[3] the ICAA has specifically endorsed the view that all investment advisers should develop and follow written codes of ethics that contain appropriate restrictions on personal trading, insider trading, and relationships with brokers, vendors and other third parties.[4]

In addition, the ICAA recently informed the Commission that it is developing a model code of ethics for investment advisers.[5] This initiative is intended to bolster efforts to enhance investor protection, to assist investment advisory firms in complying with the Commission's new regulations, to promote practices that go beyond mere strict adherence to the "black letter" rule of law, and to help educate advisory personnel of their fiduciary responsibilities. We anticipate providing the Commission with our model code in the near future.

We strongly support the SEC's proposal to require codes of ethics, with the following modifications and comments: (1) we urge the Commission to eliminate the proposed requirement that various trading records be maintained electronically; (2) we request certain clarifications regarding the proposed requirement to restrict access to nonpublic information; (3) we support flexible standards for codes of ethics; and (4) we recommend exempting non-U.S. government securities from the reporting requirements. We would be pleased to provide additional information on any of these issues and we look forward to working with the Commission in implementing this significant proposal.

II. The SEC Should Not Mandate Electronic Record-Keeping

The SEC has proposed to require that records of access persons' personal securities reports, and duplicate brokerage confirmations or account statements in lieu of those reports, be maintained electronically in an accessible computer database. We oppose this proposed requirement. Such a mandate would impose significant and unnecessary costs and burdens, particularly on small and mid-sized investment advisers. Of particular concern is the potential need to transfer duplicate brokerage confirmations and account statements into electronic format, either by scanning them or by manually transcribing the information into a computer. We understand that many brokers do not provide these documents in a format that can be

3 *Id.*, at note 55.

4 *Investment Counsel Association of America, Inc. Guidelines on Personal Investing* (Feb. 15, 1995).

5 *See* Letter from David Tittsworth, ICAA Executive Director to William H. Donaldson, SEC Chairman dated Jan. 27, 2004.

readily electronically integrated into a firm's computer database, and no corresponding broker-dealer rule requires them to do so.

We believe the proposed record-keeping requirement is premature, given current practices among many investment advisory firms. We are certainly mindful of the fact that the securities industry is continuing to make progress in achieving a variety of electronic efficiencies in trading and operations. Thus, the proposed record-keeping requirement may be less onerous to implement at some point in the future. In the meantime, however, we urge the Commission to provide flexibility for advisers to maintain personal securities transaction records either electronically or on paper.

With respect to the other record-keeping provisions in general, we applaud the Commission for simplifying rules 204-2(a)(12) and (13). The new provisions are written more clearly and will be easier for advisers to comprehend.

III. The ICAA Requests Clarification of the Provision Regarding Access to Nonpublic Information

We also request that the Commission clarify the proposed requirement to "prevent access to material nonpublic information about the adviser's securities recommendations, and client securities holdings and transactions, unless those individuals need the information to perform their duties."[6] Although we believe that this provision is intended to control confidential information from being disseminated outside the firm, we are concerned that the wording of this "need to know" standard may be construed to apply to employees within the advisory firm. We ask that the Commission clarify that this requirement only applies to the dissemination of material confidential information outside the firm. Internal restrictions are not necessary: long-standing fiduciary principles already prohibit firms and all of their supervised persons from revealing client confidences and firm's codes of ethics must be designed to prevent supervised persons from taking advantage of any nonpublic client information.

The proposed rule would permit the adviser to provide necessary information to persons providing services to the adviser or the account, such as brokers, accountants, custodians, and fund transfer agents, as well as to clients. Additionally, we believe the rule should permit disclosure of fund or model portfolio holdings information to prospective clients and their consultants, who routinely request such information in order to select an adviser. Similarly, the rule should permit disclosure of portfolio holdings information to a new client's transition manager. In such situations, an adviser could either provide stale, or non-material, portfolio holdings, or provide more up-to-date information subject to a confidentiality agreement.

[6] *Proposal* at 4.

IV. The ICAA Supports Flexible Standards for Codes of Ethics

We note that the proposal would require an adviser's code of ethics to include provisions requiring supervised persons to comply with "applicable federal securities laws." [7] We ask the Commission to clarify that the scope of this obligation extends only to the Investment Advisers Act for investment advisers that do not manage investment companies registered under the Investment Company Act of 1940. This interpretation is consistent with newly adopted Investment Advisers Act Rule 206(4)-7, which requires investment advisers to adopt formal compliance programs.

Additionally, in several instances the proposal requests comment as to whether the proposed rule should be more restrictive or specific. We believe that the rule as proposed has struck the right balance, that is, a flexible approach that allows the diverse members of the advisory profession to tailor their codes of ethics to accommodate their particular size and business activity. We support this flexible approach.

For example, it is not necessary or appropriate for the proposed rule to: (1) specify particular standards of conduct; (2) require segregation of computer files containing nonpublic information; (3) require the adviser to include the advisers' insider trading policies and procedures in the code of ethics rather than in a separate policy or compliance manual; (4) require by law an adviser's code to include various current best practices (although we encourage advisers to consider adopting the ICAA's best practice recommendations); or (5) require advisers to document the factors they considered in developing their procedures.

V. The Rule Should Exempt Non-U.S. Government Securities

The proposal exempts several securities from the reporting requirements, including: (1) money market instruments; (2) U.S. government securities; and (3) mutual funds for which the adviser or its control affiliate does not act as adviser or principal underwriter. Given the global nature of many investment advisory firms, the ICAA recommends that the exemption be extended to all government securities, including non-U.S. government securities. Similar to U.S. government securities, non-U.S. government securities "appear to present little opportunity for the type of improper trading that the access person reports are designed to uncover."[8]

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We enthusiastically support the Commission's goal of seeking to develop a rule that will encourage the investment advisory profession to renew its commitment to fiduciary

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7 *Id.*

8 *Proposal* at 8.

standards. We would be pleased to work with the Commission to implement these initiatives and appreciate the opportunity to comment on the effects of the current proposal. Please do not hesitate to contact the undersigned or ICAA General Counsel Karen L. Barr to discuss any questions the Commission or its staff may have with respect to our comments.

Sincerely,

/s/

Caroline Schaefer
Associate General Counsel

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

Joint Statement on Customer Identification Program ("CIP") and Information-Sharing between Broker-Dealers and Investment Advisers

By

Financial Planning Association
Investment Counsel Association of America
Securities Industry Association

The Securities Industry Association,[1] Investment Counsel Association of America[2] and Financial Planning Association[3] issue this joint statement to clarify the requirements of the customer identification rule issued pursuant to Section 326 of the USA PATRIOT Act of 2001 ("the Patriot Act"), and to reaffirm our members' commitment to work toward eliminating money laundering and the financing of terrorism.

SIA, ICAA, and FPA™ represent, respectively the interests of broker-dealers, SEC-registered investment advisers, and financial planners affiliated with investment advisers registered with either the SEC or state securities administrators. Because investment advisers and broker-dealers often work together in providing services to the investing public, coordination of broker-dealers and investment advisers is helpful in broker-dealers' effective implementation of the customer identification rule.

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[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry is projected to generate $142 billion in domestic revenue and $283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com)

[2] The Investment Counsel Association of America is a not-for-profit organization founded in 1937 that exclusively represents the interests of SEC-registered investment advisers. The ICAA's membership consists of more than 300 firms that manage approximately $4 trillion in assets for a wide variety of institutional and individual clients. For more information about the Association, please see our web site: www.icaa.org.

[3] The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms, with more than 28,000 individual members. Most are affiliated with investment adviser firms registered with either the SEC or state securities administrators, or both. FPA maintains administrative offices in Atlanta and Denver, and a government relations office in Washington, D.C.

- **CIP Rule Requirements**

On April 29, 2003, the SEC and the U.S. Department of the Treasury jointly issued a final rule under Section 326 of the Patriot Act that requires broker-dealers to adopt a written Customer Identification Program ("CIP"). Investment advisers are not covered by a rule under Section 326. The rule is codified at 31 C.F.R. 103.122 and is referred to herein as the "CIP Rule." The CIP Rule provides that a broker-dealer is required to implement a CIP that has procedures for: (1) verifying the identities of customers; (2) maintaining records related to the identification and verification of customers; (3) determining whether customers appear on a designated list of terrorists or terrorist organizations; and (4) providing customers with notice that information is being obtained to verify their identities.

The CIP Rule provides that a broker-dealer may fully rely on another financial institution to perform any of the required elements of the CIP for customers that are also customers of the other institution. A broker-dealer may rely on another financial institution and obtain a safe harbor from liability if the following criteria are met: (1) reliance is reasonable; (2) the other financial institution is subject to the anti-money laundering compliance program requirements of Section 352 of the Patriot Act, and is regulated by a Federal functional regulator; and (3) the other financial institution enters into a contract requiring it to certify annually to the firm that it has implemented its anti-money laundering program and that it will perform the specified requirements of the CIP, as outlined above. The reliance provisions of the CIP Rule "are designed to permit two financial institutions with mutual customers to reach agreements between themselves as to how they should allocate performance of the requirements of the rule, and thereby, rely on one another to avoid unnecessary duplication of efforts with respect to a given customer."[4]

Under the terms of the CIP Rule, broker-dealers would not be able to obtain the safe harbor by relying on SEC registered investment advisers to perform some or all of the CIP obligations because investment advisers are not yet subject to the anti-money laundering compliance program requirements of Section 352 of the Patriot Act. Although the Financial Crimes Enforcement Network (FinCEN) of the Treasury Department proposed a rule for registered investment advisers in April 2003, final rules have not yet been adopted. The Treasury Department's proposed anti-money laundering requirements for investment advisers would apply only to advisers registered with the SEC. State-registered investment advisers would be exempt from the requirements under the proposal.

[4] Letter dated February 12, 2004 to Alan E. Sorcher, Associate General Counsel, Securities Industry Association, from Annette L. Nazareth, Director, SEC Division of Market Regulation regarding Broker-Dealer Customer Identification Rule ("No-Action letter").

- **Reliance on Registered Investment Advisers**

On February 12, 2004, the SEC issued a No Action letter stating that pending finalization of the proposed rules relating to registered investment advisers, broker-dealers will be able to rely on investment advisers under the reliance provisions of the CIP Rule to perform some or all of the CIP.[5] Under the terms of the No-Action letter, broker-dealers may treat registered investment advisers as if they are financial institutions subject to an AML Rule provided all of the other requirements and conditions in paragraph (b)(6) of the CIP Rule (31 C.F.R. § 103.122(b)(6)), are met, namely that:

(1) Such reliance is reasonable under the circumstances;
(2) The investment adviser is regulated by a Federal functional regulator; and
(3) The investment adviser enters into a contract requiring it to certify annually to the broker-dealer that it has implemented an anti-money laundering program, and that it will perform (or its agent will perform) specified requirements of the broker-dealer's customer identification program.

The letter will be withdrawn automatically on the earlier of the date upon which an AML rule for advisers becomes effective, or February 12, 2005.

Broker-dealers and registered investment advisers considering whether to enter into reliance relationships under the terms of the No-Action letter are reminded that: 1) there is no requirement to enter into such relationships and such relationships are voluntary; 2) SEC registered investment adviser firms are not presently required under federal law to establish anti-money laundering or CIP programs; 3) broker-dealers should consider the reasonableness of their reliance on an investment adviser's program; and 4) an investment adviser that chooses to enter into such relationship should carefully consider whether its anti-money laundering program is fully compliant with the Patriot Act and any attendant liability.

Members should also be aware that the Treasury Department and SEC issued guidance on October 1, 2003 that clarifies the requirements for broker-dealers that engage in transactions through omnibus accounts, including sub-accounts, established by financial intermediaries, such as investment advisers. The guidance clarifies that for broker-dealers engaging in transactions through omnibus accounts and sub-accounts established by financial intermediaries, the financial intermediary, and not the beneficial owners of the omnibus account or sub-account, should be treated as the customer if certain conditions are satisfied.

FPA, ICAA and SIA encourage their members and others in the securities industry, whether or not they are subject to the Patriot Act's requirements, to implement anti-money laundering policies and procedures, where appropriate. The associations

[5] The letter is available on the SEC's website at: http://www.sec.gov/divisions/marketreg/mr-noaction/sia021204.htm

further encourage their members to seek ways to meet the spirit and intent of the CIP Rule in a cooperative fashion, and to work together and share information, where permissible, in an effort to better protect the U.S. financial system from being used to facilitate illicit activity.

ICAA

Statement of

Geoffrey I. Edelstein, CFA, CIC
Managing Director, Westcap Investors

Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Examining Soft-Dollar Practices

Before the
U.S. Senate Committee on
Banking, Housing, and Urban Affairs

March 31, 2004

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Statement of Geoffrey I. Edelstein, CFA, CIC

Before the
U.S. Senate Committee on Banking, Housing, and Urban Affairs

March 31, 2004

Chairman Shelby, Ranking Member Sarbanes, and members of the Committee, I greatly appreciate the opportunity to appear before you today to address issues related to soft dollars. On behalf of the Investment Counsel Association of America (ICAA), I wish to commend the Committee for convening this and other hearings on issues related to current investigations and regulatory actions regarding the mutual fund industry.

I am a Managing Director and Co-Founder of Westcap Investors, LLC, an investment advisory firm located in Los Angeles. Westcap was founded in 1992 and is registered as an investment advisory firm with the Securities and Exchange Commission.[1] Our firm provides investment advisory services to both individuals and institutions. Our clients include a wide variety of individual investors as well as pension and profit sharing plans, charitable organizations, corporations, state and municipal government entities, and pooled investment vehicles, such as limited liability companies and mutual funds (as a subadviser). Today, our firm employs 43 people and is majority-owned by its employees. Westcap's current assets under management total about $2.8 billion.[2]

The Investment Counsel Association of America[3] is a non-profit organization based in Washington, DC that represents the interests of SEC-registered investment advisory firms. Westcap has been a member of this organization for many years and I am pleased to offer my testimony today on behalf of the ICAA. A statement on soft dollars that was released by the ICAA earlier this month is included as part of my statement.

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[1] Section 202(11) of the Investment Advisers Act of 1940 defines an investment adviser as "any person, who, for compensation, engages in the business of advising others. . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . ." This section also sets forth several exceptions to the definition.

[2] As with all other SEC-registered investment advisers, Westcap's Form ADV Part 1 is publicly available on the Investment Adviser Public Disclosure web site: www.adviserinfo.gov. This required registration and disclosure form provides information about an investment advisory firm, its principals, its clientele, any disciplinary history, and various activities.

[3] The ICAA's membership consists of more than 300 SEC-registered investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. For more information, please visit: www.icaa.org.

Summary of Positions

- Investment advisers are fiduciaries and, as such, have an obligation to seek best execution in connection with client transactions and to disclose potential conflicts of interests to both existing and prospective clients. Client brokerage is an asset of the client – not of the adviser, and thus there is a potential conflict where an adviser uses client brokerage for research. Accordingly, the ICAA supports full and appropriate disclosure of soft dollar practices by all investment advisers. Consistent with the basic approach of U.S. securities laws and market principles, we strongly believe that the SEC should ensure that there is adequate disclosure about soft dollar practices, combined with appropriate inspection and enforcement of regulations governing these practices.

- The ICAA fully supports the SEC's current initiative to examine soft dollar practices. Specifically, the ICAA believes the SEC should conduct a rulemaking aimed at ensuring that required disclosures related to soft dollar arrangements are adequate and appropriate and to clarify the current definition of "research." The consequences of abolishing soft dollars – an outcome that would require Congressional action – likely will adversely affect smaller investment advisory firms, create entry barriers for new investment advisory firms, and diminish the quality and availability of proprietary and third-party research. Consequently, the ICAA strongly believes that a rulemaking is the best option for considering and implementing changes in this important area.

- The ICAA supports appropriate recordkeeping requirements for investment advisers regarding soft dollar transactions. Investment advisers should maintain appropriate documentation of soft dollar transactions, the services received, their uses, and allocation methodologies for mixed-use items (a service or product that provides both research and other uses). In addition, the ICAA believes that investment advisers should develop and implement appropriate internal controls and procedures that are designed to ensure that soft dollar arrangements are supervised, controlled, and monitored.

- As set forth in the ICAA's March 3 statement, however, we oppose the suggestion that the SEC should eliminate the use of soft dollars for third-party research. We believe this approach would harm investors and diminish the availability of quality research. It would result in an unjustifiable, unlevel playing field for many market participants. It would provide a regulatory-driven advantage for full-service brokerage firms and disadvantage third-party research providers. Ironically, eliminating soft dollars for third-party research also would result in less transparency to investors, regulators, and market participants.

Profile of the Investment Advisory Profession

The profile of the investment advisory profession is often mischaracterized and misunderstood. Investment companies (mutual funds) and the investment management companies that provide investment advice to mutual funds constitute a significant and important part of the investment advisory profession. However, mutual fund companies and their advisers comprise only a portion of the entire investment advisory profession. In fact, statistics indicate that the vast majority of SEC-registered investment advisory firms are *small* companies and that most of them do *not* manage mutual funds.

Beginning in 2001, investment advisers have been required to use an electronic filing system – the Investment Adviser Registration Depository (IARD) – when submitting Form ADV, Part 1, the basic registration and disclosure document required by the SEC.[4] Since then, the ICAA and National Regulatory Services have issued annual reports profiling the investment advisory profession based on these required filings. In 2003, we reported that there were a total of 7,852 entities registered with the SEC as investment advisers. Of this total, 5,299 (67.5%) reported having 10 or fewer employees. On the other end of the spectrum, only 260 (3.3%) of all SEC-registered investment advisory firms reported that they employ more than 250 persons. And only 1,478 (less than 20%) of all SEC-registered investment advisers reported that they provide portfolio management for mutual funds (investment companies).[5]

While a relatively few large firms dominate the investment advisory profession in terms of their collective assets under management, the fact remains that most investment advisory firms are small businesses that are extremely diverse, both in terms of the investment services they provide and the extremely wide range of investors they serve. We submit that this fact should be considered carefully in making any significant regulatory or policy decisions that affect investment advisers.

Definition of Soft Dollars/Proprietary vs. Third-Party Research

The subject of today's hearing is often misunderstood and controversial, in part due to the unfortunate term, "soft dollars." Soft dollars simply refers to the provision by broker-dealers of research in addition to execution of securities transactions in exchange for commission dollars. The SEC staff has described soft dollar arrangements as follows:

> Research is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business. Soft dollar arrangements have developed as a link between the brokerage industry's supply of research and the money management industry's demand for research.

[4] In general, any investment adviser that manages in excess of $25 million must file Form ADV, Part 1 via the IARD system.

[5] *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession*, Investment Counsel Association of America and National Regulatory Services (May 2003). The report is posted on the ICAA's web site: www.icaa.org.

> Broker-dealers typically provide a bundle of services including research and execution of transactions. The research provided can be either proprietary (created and provided by the broker-dealer, including tangible research products as well as access to analysts and traders) or third-party (created by a third party but provided by the broker-dealer). Because commission dollars pay for the entire bundle of services, the practice of allocating certain of these dollars to pay for the research component has come to be called "softing" or "soft dollars."[6]

As noted in the SEC's report, soft dollar arrangements generally can be categorized as either "proprietary" or "third party." When the broker-dealer that executes a trade also provides internally generated research in exchange for one bundled commission price, that arrangement is referred to as "proprietary." This is often also referred to as "Wall Street research." Wall Street, or full-service brokerage firms, will not break out the costs to purchase these proprietary services "a la carte" to the vast majority of its clients. Instead of proprietary research, however, the executing broker can provide independent research generated by third parties in exchange for commission dollars. In these instances, the executing broker must be obligated to pay for the third party research provided to the investment adviser in order for the arrangement to fall within the 28(e) safe harbor. These "third-party" arrangements are an important mechanism for the distribution of independent research and analytic services.

Several issues are raised by soft dollar arrangements. First, the commissions used for execution and research services are paid by the investment advisers' clients. As such, an investment adviser has the obligation to use these commissions in the best interests of its clients and consistent with its fiduciary duties. Second, because proprietary research is bundled with execution services, the costs of research, execution, and other services are not as transparent as they would be if charged separately. Third, the definition of what is allowable research has been blurred as new products and services are created, particularly those using various technological innovations. Ultimately, we believe these issues are best addressed by ensuring that investors receive full and accurate disclosure of soft dollar arrangements; by clearly delineating the types of research services that are eligible in such arrangements; and by giving the SEC appropriate tools and resources for inspection and enforcement activities.

Fiduciary Duty

Investment advisers are subject to a fundamental fiduciary duty. This duty has been upheld by the U.S. Supreme Court[7] and reiterated by the SEC in various pronouncements over the years.[8] As described in the following excerpt, an investment

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[6] *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds,* The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (Sept. 22, 1998).

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

[8] *See, e.g., In re: Arleen W. Hughes,* Exchange Act Release No. 4048 (Feb. 18, 1948). "The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment

adviser's fiduciary duty is one of the primary distinctions between investment advisers and others in the financial services industry:

> As a fiduciary, an adviser owes its clients more than honesty and good faith alone. Rather, an adviser has an affirmative duty of utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the client's. Pursuant to this duty, an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions.[9]

Among obligations that flow from an adviser's fiduciary duty are: (1) the duty to have a reasonable, independent basis for its investment advice; (2) the duty to seek best execution for clients' securities transactions where the adviser is in a position to direct brokerage transactions; (3) the duty to ensure that its investment advice is suitable to the client's objectives, needs, and circumstances; (4) the duty to refrain from effecting personal securities transactions inconsistent with client interests; and (5) the duty to be loyal to clients.[10]

Since it was founded in 1937, the ICAA has emphasized an adviser's fiduciary duty as a cornerstone of an investment adviser's obligations.[11] In the soft dollar context, we believe that fiduciary principles require an investment adviser to make appropriate disclosure to their clients about soft dollar practices. Appropriate disclosure will allow investors to make informed judgments about such practices based on all relevant facts. In addition, fiduciary principles require investment advisers to make trade execution decisions in the best interests of their clients in light of relevant facts and circumstances.[12]

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advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice 'in almost every instance.' This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients."

[9] Lemke & Lins, *Regulation of Investment Advisers,* at p. 174 (2003).

[10] *Id.,* at p. 175.

[11] "An investment adviser is a fiduciary and has the responsibility to render professional, continuous, and unbiased investment advice oriented to the investment goal of each client." *ICAA Standards of Practice.*

[12] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters,* Exchange Act Release No. 23170 (Apr. 23, 1986).

Disclosure and Transparency

Disclosure is a bedrock principle of the U.S. securities laws. As a general matter, in fulfilling its fiduciary obligations to clients, an investment adviser is required to make full and fair disclosure of all material facts necessary for informed decision-making by clients, particularly where a potential conflict of interest is involved.

One of the primary disclosure tools required of investment advisers is Form ADV, Part II, or the so-called "brochure." The brochure is the key disclosure document that all investment advisers must deliver to existing and prospective clients (and offer to clients each year).

In the soft dollar context, Form ADV, Part II requires investment advisers to disclose information related to brokerage and commissions. Specifically, Item 12 requires disclosure regarding whether: (a) the adviser or a related party has authority to determine, without specific client consent, the broker-dealer to be used in any securities transaction or the commission rate to be paid, and (b) the adviser or a related party suggests broker-dealers to clients. If the adviser engages in either of these practices, it is required to describe the factors considered in selecting broker-dealers and in determining the reasonableness of commissions charged. If the value of research products or services given to the adviser or a related party is a factor in these decisions, the adviser must describe the following:

1. The research products and services;
2. Whether clients may pay commissions higher than those obtainable from other broker-dealers in return for these products and services;
3. Whether research is used to service all of the adviser's clients or just those accounts whose commission dollars are used to acquire research products or services; and
4. Any procedures the adviser has used during the past fiscal year to direct client transactions to a particular broker-dealer in return for research products or services.

The SEC has proposed enhancements to these soft dollar disclosures by investment advisers. While the proposal has not yet been finalized, the ICAA anticipates final action later this year. Following is an excerpt from the SEC's regulatory proposal that describes these enhancements (all footnotes omitted):[13]

> *Soft Dollar Practices*. Advisers often receive "soft dollar" benefits from using particular brokers for client trades. Client brokerage, however, is an asset of the client – not of the adviser. When, in connection with client brokerage, an adviser receives products or services that it would otherwise have to produce itself (or pay for), the adviser's interest may conflict with those of its clients. For example, soft

[13] *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Advisers Act Release No. 1862 (Apr. 5, 2000).

dollar arrangements may cause an adviser to violate its best execution obligation by directing client transactions to brokers who are not able to adequately execute the transactions, or may give the adviser incentive to trade client securities more often than it would absent the benefits the adviser receives. Because of these conflicts, we have required advisers to disclose their policies and practices on use of client brokerage to obtain soft dollar benefits.

During 1997-98, our staff conducted a wide-ranging examination of advisers' soft dollar practices and disclosure. Our Office of Compliance Inspections and Examinations found widespread use of soft dollars by investment advisers that manage client portfolios. The Office concluded that advisers' disclosure often failed to provide sufficient information for clients or potential clients to understand the adviser's soft dollar practices and the conflicts those practices present. In its report, the Office noted that most advisers' descriptions were simply boilerplate, and urged that we consider amending Form ADV to require better disclosure. Today we are acting on those recommendations.

Item 11 would require an adviser that receives research or other products or services in connection with client securities transactions (soft dollar benefits) to disclose the adviser's practices and discuss the conflicts of interest that result. The brochure's description of soft dollar practices must be specific enough for clients to understand the types of products or services the adviser is acquiring and permit them to evaluate conflicts. Disclosure must be more detailed for products or services not used in the adviser's investment decision-making process.

Item 11 would describe the types of conflicts the adviser must disclose when it accepts soft dollar benefits, and require the adviser to disclose its procedures for directing client transactions to brokers in return for soft dollar benefits. The item would require the adviser to explain whether it uses soft dollars to benefit all clients or just those accounts whose brokerage "pays" for the benefits, and whether the adviser seeks to allocate the benefits to client accounts proportionately to the brokerage credits those accounts generate. The item would also require the adviser to explain whether it "pays up" for soft dollar benefits.

These enhanced disclosures will put more detailed information in the hands of clients, permitting clients to decide whether they approve of their advisers' use of their commissions.

In addition to disclosure and other regulatory requirements, there are a number of market factors that play a significant role in soft dollar arrangements. For example, many investment advisory clients (or their consultants) request and receive extensive information relating to soft dollar practices. These requests often extend to information that go beyond disclosures required by regulations, including specific client information. The fact of the matter is that investment advisers often supply a great deal of information regarding soft dollar practices in response to requests from clients or their consultants.

Similarly, it should be recognized that excessive trading or paying excessive commissions to "earn" soft dollar credits for research takes an adverse toll on an investment adviser's investment performance (by creating additional trading costs that must be deducted from any appreciation in value of a client's account). This fact alone serves as an important "market" deterrent from abusing soft dollar arrangements. Investment performance is clearly the single most significant factor that investors (and their consultants) use to hire or fire an investment adviser. Accordingly, investment advisers whose clients are able to monitor their portfolios and investment performance will be sensitive to potential negative effects that may follow from trading activities associated with soft dollar arrangements. In addition, clients (including mutual fund directors) receive independent custodial reports and can judge for themselves the appropriateness of commissions paid and the turnover of securities in their portfolios.

The ICAA supports full and appropriate disclosure of soft dollar practices by all investment advisers. Consistent with the basic approach of U.S. securities laws and market principles, we believe that the SEC should ensure that there is adequate disclosure about soft dollar practices, combined with appropriate inspection and enforcement of such regulations.

Definition of "Research"

Section 28(e) of the Securities Exchange Act of 1934 was enacted by the Congress in 1975 following the abolition of fixed commission rates. The section provides that: "no person . . . in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law . . . solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of the commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercise investment discretion."

In order to rely on the safe harbor under section 28(e), an investment adviser must satisfy the following conditions:

- The adviser must be supplied with "brokerage and research" services;
- The services must be "provided" by a broker-dealer;
- A "broker-dealer" must be the provider of the service;
- The investment adviser must have "investment discretion" in placing the brokerage;

- The commissions paid must be "reasonable" in relation to the services provided;

- "Commissions" must be used to purchase the services; and

- The brokerage commissions paid must relate to "securities transactions."

One of the most important aspects of the safe harbor is the definition of "research" services. The leading pronouncement on this issue is the SEC's 1986 interpretive release. According to the 1986 release, the test for determining "whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his decision-making responsibilities."[14] The SEC noted that what constitutes lawful and appropriate assistance "in any particular case will depend on the nature of the relationships between the various parties involved and is not susceptible to hard and fast rules." In later decisions, the SEC has noted that "research" does *not* cover a wide variety of expenses, including overhead (such as office rent, utilities, and salaries), administrative expenses, exam review courses, association membership dues, electronic proxy voting services, consulting services designed to assist an investment adviser in client marketing, legal expenses, accounting and tax software, as well as items such as travel, meals, hotel and entertainment expenses associated with attending a research seminar or conference.[15]

The 1986 interpretive release specifically identified so-called "mixed-use" products and services that may have both research and non-research purposes. Among such mixed-use products are: computer equipment used for research undertaken on behalf of clients and for non-research functions, such as bookkeeping or administrative operations; quotation systems that provide information pertinent to the valuation of securities while facilitating the adviser's reports to clients; and information management systems that integrate trading, execution, accounting, recordkeeping, and other administrative functions. The SEC requires investment advisers that receive a mixed-use product or service to make a reasonable allocation of the cost of the product or service according to its use.

Since the enactment of section 28(e) in 1975, investment advisers have begun to use investment styles that require quantitative analytic tools that are in some ways quite different from the traditional research tools used by investment advisers. In addition, the way that research is delivered has significantly changed since 1986, when the SEC last defined "research." The predominant form of research in 1975 – paper documents covering one issuer – have now developed into a myriad of research services, including

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[14] *Supra*, fn.10.

[15] *In re Kingsley, Jennison, McNulty & Morse, Inc.*, Advisers Act Release No. 1396 (Dec. 23, 1993); *In re Goodrich Securities Inc.*, Exchange Act Release No. 28141 (June 25, 1990); *In re Patterson Corp.*, Advisers Act Release No. 1235 (June 25, 1990).

electronic delivery and software that provides consolidations of research covering entire sectors, industries, and other categories into searchable, analytical databases. These changes have presented many challenges for advisers attempting to interpret the SEC's guidance from 1986.

The ICAA supports the SEC's efforts to ensure that soft dollars are used only for legitimate research purposes. We also recognize the difficult challenges associated with this task. Particularly given advances in technology, including communications and electronics, the line between research and non-research products and services is more difficult to discern and to delineate. We support a rulemaking by the SEC to clarify the definition of research to preclude the use of soft dollars for non-research products and services while retaining enough flexibility so as not to preclude the development of innovative and valuable research services.

1998 SEC Report on Soft Dollar Practices

The best starting point for evaluating actual practices related to soft dollars is the report issued by the SEC's Office of Compliance Inspections and Examinations (OCIE) in 1998.[16] From November 1996 through April 1997, OCIE conducted an extensive inspection sweep to gather information about the current uses of soft dollars, based on on-site examinations of 75 broker-dealers and 280 investment advisers and investment companies. In September 1998, OCIE issued a written report detailing the results of their sweep and setting forth recommendations for consideration by the SEC. Among the key findings set forth in the report are the following:

1. "Almost all" investment advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services.

2. Most products and services obtained by investment advisers with soft dollars fall within the definition of research, *i.e.*, they provide lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities.

3. While most of the products acquired with soft dollars are research, OCIE found that a significant number of broker-dealers (35%) and investment advisers (28%) provided and received non-research products and services in soft dollar arrangements. In such cases, OCIE found that investment advisers failed to provide meaningful disclosure to their clients.

4. OCIE also reported shortcomings by investment advisers with respect to "mixed use" items, *i.e.*, products that have both research and non-research uses.[17]

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[16] *Supra*, fn. 4.

[17] *Id.*, at p. 3.

The staff report set forth the following recommendations for the SEC to consider:

"1. We noted many examples of advisers claiming the protection of the safe harbor without meeting its requirements. We also found that industry participants were not uniformly following prior Commission guidance with respect to soft dollars. As a result, we recommend that the Commission publish this report to reiterate guidance with respect to the scope of the safe harbor and to emphasize the obligations of broker-dealers, investment advisers and investment companies that participate in soft dollar arrangements. We also recommend that the Commission reiterate and provide further guidance with respect to the scope of the safe harbor, particularly concerning (a) the uses of electronically provided research and the various items used to send, receive and process research electronically, and (b) the uses of items that may facilitate trade execution.

"2. Many broker-dealers and advisers did not keep adequate records documenting their soft dollar activities. We believe that the lack of adequate recordkeeping contributed to incomplete disclosure, using soft dollars for non-research purposes without disclosure, and inadequate mixed-use analysis. We recommend that the Commission adopt recordkeeping requirements that would provide greater accountability for soft dollar transactions and allocations. Better recordkeeping would enable advisers to more easily assure compliance and Commission examiners to more readily ascertain the existence and nature of soft dollar arrangements when conducting inspections.

"3. We noted many instances where advisers' soft dollar disclosures were inadequate or wholly lacking – especially with respect to non-research items. We recommend that the Commission modify Form ADV to require more meaningful disclosure by advisers and more detailed disclosure about the products received that are not used in the investment decision-making process. In addition, the Commission should require advisers to provide more detailed information to clients upon request.

"4. In light of the weak controls and compliance failures that we found, we recommend that the Commission publish this report in order to encourage advisers and broker-dealers to strengthen their internal control procedures regarding soft dollar activities. We suggest that advisers and broker-dealers review and consider the controls described in this report, many of which were observed as effective during examinations."[18]

At the time it was issued, the OCIE report clearly represented the best available information on soft dollar practices. In light of the fact that the report was published more than 5 years ago, one of the key questions today is whether any of the practices described in the report have changed. Some of the key issues that may warrant re-

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[18] *Id.*, at pp. 4-5.

examination include whether documentation, disclosure, and control procedures relating to soft dollar arrangements have improved.

Current SEC Initiatives

Following the recommendations set forth in the 1998 OCIE Report, the SEC issued an extensive proposal in April 2000 to revise the so-called "brochure" (Form ADV, Part 2), the disclosure document that all investment advisers must offer to provide to clients and prospective clients each year.[19] As discussed above, the proposed rule would amend the brochure requirements to mandate more specific disclosure regarding soft dollar practices and any resulting conflicts. The ICAA expects the SEC to finalize this important rule later this year.

In addition, the SEC recently finalized a major new rule that requires all investment advisers to adopt written compliance policies and procedures that are reasonably designed to prevent violations of the Investment Advisers Act of 1940, to review such policies and procedures at least annually, and to designate a chief compliance officer who is responsible for administering the policies and procedures.[20] The written release accompanying the SEC's new regulation lists a number of areas that investment advisers should consider in developing written policies and procedures, including best execution and soft dollar practices. Clearly, the new rule will encourage investment advisers to enhance – and review on a continuing basis – their written policies and procedures relating to soft dollar practices and will provide the SEC with an additional tool in identifying potential problems in this area.

Early this year, Chairman Donaldson announced that he has directed SEC staff to explore various issues relating to soft dollars. SEC staff have been meeting with a number of interested parties to discuss issues related to soft dollar practices, including contracts for soft dollar arrangements, recordkeeping practices, and disclosure practices. At the March 10 hearing before this Committee, the Director of the SEC's Division of Investment Management noted in his prepared testimony that:

> Chairman Donaldson has made the issue of soft dollars a priority and has directed the staff to explore the problems and conflicts inherent in soft dollar arrangements and the scope of the safe harbor contained in Section 28(e) of the Securities Exchange Act. The Divisions of Market Regulation and Investment Management, along with the Office of Compliance, Inspections, and Examinations, are working together to conduct this review. A primary area of focus is whether the current definition of qualifying "research" under the safe harbor is too broad and should be narrowed by rulemaking. The Commission has also sought public comment on

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[19] *Supra,* fn. 11.

[20] *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204 (Dec. 17, 2003).

whether it would be possible to require mutual fund managers to identify the portion of commission costs that purchase research services from brokers so as to enhance the transparency of these arrangements.[21]

We understand that as part of this review, the SEC is considering certain public comments that have been filed with the SEC that set forth a number of suggestions for improving disclosure of soft dollar arrangements and for narrowing the scope of allowable research.[22] Among these comments is a suggestion that proprietary research costs be "unbundled" from execution costs.[23] Although we have not had an opportunity to fully consider this proposal, we strongly believe that any such reform should place full responsibility to calculate the cost or price of non-execution services on the broker-dealer providing the services, rather than requiring investment advisers to make a subjective estimate regarding such services.

The ICAA fully supports the SEC's current initiative to examine soft dollar practices and issues. Specifically, the ICAA would support an SEC rulemaking aimed at improving disclosure of soft dollar practices and arrangements to investors and to clarify the current definition of "research."

Conclusions and Summary

In summary, the ICAA supports a rulemaking by the SEC that would:

- Enhance soft dollar disclosure requirements, as envisioned by the SEC's proposal to revise Form ADV;

- Strengthen books and records requirements related to soft dollars; and

- Clarify the scope of allowable "research" within the section 28(e) safe harbor.

We believe that these rule changes, combined with appropriate inspection and enforcement of these regulations will strengthen the transparency of soft dollar arrangements and deter abuses in this area.

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[21] *Testimony Concerning the Securities and Exchange Commission's Recent Regulatory Actions to Protect Mutual Fund Investors*, Paul F. Roye, Director, SEC's Division of Investment Management, before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Mar. 10, 2004).

[22] *See March 2, 2004 Comment Letter from Fidelity Management and Research Company to SEC re: Concept Release on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Release No. 33-8349; 34-48952: IC-26313; File No. S7-29-03*.

[23] *Id.*

However, we believe that the SEC should reject suggestions to eliminate the use of soft dollars for third-party research.[24] As described in the ICAA's March 3, 2004 statement, we believe such a suggestion is fundamentally flawed:

> It would result in a diminution of quality research and thus is contrary to our strong support for independent research that benefits investors. If adopted, the proposal would unfairly advantage full-service brokerage firms and disadvantage third-party research providers, as well as clients of investment advisers who benefit from third-party research.

Finally, the ICAA believes that an SEC rulemaking is a better approach than repealing section 28(e). While the consequences of eliminating soft dollars cannot be predicted with certainty, we believe the SEC is in the best position to consider the complex issues related to this important question. Abolishing soft dollars may well diminish the amount of quality research that is made available to investment advisers and thus may hurt investors. In addition, repealing section 28(e) may disproportionately disadvantage thousands of smaller investment advisory firms and their clients while favoring the relatively few larger firms that have greater resources to produce and acquire research.

In closing, the ICAA wishes to commend the Committee for conducting this hearing on these important issues. We would be pleased to provide any additional information that may be helpful to you in your continuing deliberations.

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[24] *See December 2, 2003 Comment Letter from the Investment Company Institute to the SEC re: soft dollars.*
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ICAA

April 27, 2004

Via Electronic Filing

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

Re: Proposed Rule: Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies; Release Nos. 33-8364; 34-49219; IC-26350; File No. S7-08-04

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments regarding the Commission's proposed rule amendments to require mutual funds to provide additional disclosure to shareholders regarding the material factors and the conclusions with respect to those factors that formed the basis for their board of directors' approval of advisory contracts.[2]

Specifically, the proposed disclosure must discuss factors relating to the board's selection of the adviser and approval of the advisory fee and any other amounts to be paid by the fund under the contract. These factors would include: (1) the nature, extent, and quality of the services to be provided by the adviser; (2) the investment performance of the fund and adviser; (3) the costs of the services to be provided and profits to be realized by the adviser and its affiliates from the relationship with the fund; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies

[1] The ICAA is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 300 investment advisory firms that collectively manage approximately $4 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[2] *Proposed Rule: Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, SEC Release Nos. 33-8364; 34-49219; IC-26350; File No. S7-08-04 (Feb. 11, 2004). The rule would amend Schedule 14A, the schedule used by registered investment companies and issuers registered under section 12 of the Securities Exchange Act of 1934 for proxy statements pursuant to section 14(a) of the Exchange Act, and Forms N-1A, N-2, and N-3, the registration forms used by management investment companies to register under the Investment Company Act of 1940 and to offer their securities under the Securities Act of 1933.

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of scale. The fund would also be required to indicate whether the board relied on comparisons of the services rendered and fees paid with those under other investment advisory contracts, and, if so, how these comparisons assisted the board in deciding to approve the contract.

The SEC states that the proposal is intended to provide fund shareholders with more timely disclosure of the reasons for the board's approval of an investment advisory contract. The Commission believes that this increased disclosure "may encourage fund boards to consider investment advisory contracts more carefully and investors to consider more carefully the costs and value of the services rendered by the fund's investment adviser."[3] We commend the Commission for seeking to improve fund oversight by directors, to increase fund directors' accountability to fund shareholders, and to assist directors with satisfying their statutory duties under section 15(c) of the Investment Company Act when they recommend approval of an investment advisory contract. We write simply to discuss the appropriate type of fund disclosure regarding the costs and profits of the adviser.

This proposed disclosure item raises several issues. First, there are different methods of calculating costs and estimating profitability. The determination of the costs of the services provided and the profit realized is subjective and involves many different factors and elements. The advisory fee for mutual funds (also referred to as the management fee) often includes compensation for portfolio management services, administrative fees, and various other services. An adviser's costs may also include costs of operations and services applicable to many funds and other clients. Different advisers may not attribute costs among their advised funds uniformly. The process of ascertaining various components of costs attributable to services provided to a particular fund involves an adviser's judgment and is not easily standardized or comparable from adviser to adviser. Similarly, the elements of profitability may not be comparable across funds. Because costs and profits may be subjective and non-uniform among funds, the process by which the board evaluates these various elements is the most important information to provide to investors.[4]

Second, cost and profit information is proprietary information. Disclosure of such information could have a harmful competitive effect on investment advisers. For example, many advisers would not want their competitors to know the details of their cost structure.[5] We respectfully submit that other substantial information that the adviser provides to the board provides a more than adequate basis for disclosure. For example, under the proposal, the fund will be required to discuss how the board considered economies of scale. This factor will necessarily incorporate costs, expenses and profits of an adviser to some extent. Moreover, the reasonableness of an advisory fee depends on several factors, many of which are unrelated to the adviser's internal operating costs and profit structures, such as investment

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[3] *Id.* at 4.

[4] This type of disclosure is consistent with the Commission's intent "to promote insightful disclosure of the board review process." *See* Speech by Paul F. Roye, Director of Division of Investment Management, "Integrity and Accountability: The New Imperatives for the Mutual Fund Industry" (Mar. 22, 2004).

[5] Similarly, specific information about an adviser's advisory agreements with other clients is proprietary and confidential information, the disclosure of which may be anti-competitive or violate the adviser's duty of confidentiality to its clients.

style and strategy, the experience and expertise of the firm's portfolio management team, the type and size of the fund managed, the fund's expense ratio and turnover, and the fund's performance.

Third, current laws and rules already impose significant obligations on fund directors and advisers with respect to investment advisory compensation and contracts. Directors are required under section 15(c) to satisfy their duty "to request and evaluate . . . such information as may reasonably be necessary to evaluate the terms of any [advisory] contract." In addition, advisers are required by section 15 to furnish such information to the fund board. Further, section 36(b) of the Investment Company Act imposes on an adviser to a registered investment company "a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser." Finally, advisers under the Investment Advisers Act owe a fiduciary duty to their clients, including mutual funds whose interests are represented by the fund's board of directors, to act in their clients' best interests.

Accordingly, fund directors have a statutory obligation to review the appropriateness of the advisory contract for fund shareholders. It is the responsibility of the board to evaluate information and make inquiries necessary to ensure the protection of fund investors. Regardless of disclosure requirements, directors are entitled to request any information they deem relevant to the analysis of whether an advisory fee bears a reasonable relationship to the services the adviser is providing. Directors are also entitled to consider the adequacy of the information provided by the adviser in analyzing fees. Advisers and fund directors are able to discuss and negotiate the type of information provided. For example, advisers may agree to provide certain types of cost and profit information on a confidential basis to the board. We submit that such agreements should not be vitiated by disclosure requirements to the contrary.

For all of these reasons, we respectfully request that the Commission confirm that the fund is required to include a discussion of the process by which the board analyzed the costs and profits of the adviser with respect to the fund, without identifying specific proprietary and confidential operating cost and profit information.[6]

[6] Similarly, with respect to any comparisons to contracts with other clients of the investment adviser, the fund should be permitted to discuss consideration of the factor, rather than disclose specific information regarding the adviser's other contracts. General information regarding the adviser's fee schedule is already disclosed in Item 1.D of Form ADV, Part II, which all registered advisers must provide to clients.

We appreciate the opportunity to comment on the potential effects of the proposed rule on investment advisers. Please do not hesitate to contact the undersigned or ICAA General Counsel Karen Barr to discuss any questions the Commission or its staff may have with respect to our comments.

Sincerely,

Monique S. Delhomme

Monique S. Delhomme
ICAA Counsel

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
Paul F. Roye, Director, Division of Investment Management

ICAA

May 21, 2004

Via Electronic Filing

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

Re: Proposed Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Release Nos. 33-8396; 34-49398; IC-26383; File No. S7-12-04

Dear Mr. Katz:

The Securities and Exchange Commission has proposed amendments to its forms under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 to improve the disclosure provided by registered investment companies (funds) regarding their portfolio managers.[1] The proposal would expand an existing requirement that a fund provide basic information in its prospectus regarding its portfolio managers to include the members of management teams. Funds would also be required to disclose additional information about their portfolio managers, including: (1) other accounts they manage; (2) their compensation structure; and (3) their ownership of securities in accounts they manage.

The Investment Counsel Association of America[2] strongly supports the goal of increasing transparency regarding the identity of portfolio managers, their incentives in managing a fund and the potential conflicts of interest raised by managing multiple investment accounts, and we applaud the Commission for issuing this important proposal. The ICAA supports the proposal with the comments and proposed modifications discussed below.

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1 *Proposed Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies*, SEC Release Nos. 33-8396; 34-49398; IC-26383; File No. S7-12-04 (Mar. 11, 2004) (proposal).

2 The ICAA is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 300 investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

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1. Identification of Portfolio Management Team Members

Funds are currently required to disclose basic information about the portfolio managers who are primarily responsible for the day-to-day management of the fund's portfolio;[3] however, funds are not currently required to disclose the identities of members of a portfolio team that manages the fund's portfolio.[4] The proposal would amend fund registration Forms N-1A and N-2 to require the disclosure of "each member of a committee, team, or other group of persons associated with a fund's investment adviser that is jointly and primarily responsible for the day-to-day management of the fund's portfolio."[5]

The ICAA supports disclosure of the proposed basic information about portfolio managers who have decision-making authority for the portfolio, regardless of whether the decision-maker is a single individual or several individuals who are part of a committee or team. We are concerned, however, that the definition of "jointly and primarily responsible" may be interpreted inappropriately to extend beyond members of a committee or team who have decision-making authority.

While portfolio management teams often include individuals who perform functions related to management decisions, such individuals are not necessarily empowered to make final investment or management decisions. For example, we understand that some portfolio management teams are made up of a combination of portfolio managers, who have equal authority to determine management decisions, and analysts, who have no decision-making authority. Moreover, the composition of a portfolio management team can be designed by an advisory firm to be flexible and members of teams who are not key decision-makers may be assigned among funds depending on the adviser's needs at a particular time.

Thus, there are several unfavorable outcomes that may result from a requirement to disclose information about every member of a portfolio management team.[6] A significant concern is that the most important information about key decision-makers may be obscured by lengthier discussions and less important information regarding every member of a team. Such a requirement could also inhibit an adviser's discretion to reorganize the composition of a team to the detriment of fund shareholders. Additionally, the costs associated with maintaining current disclosure would likely increase.

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3 See Item 5(a)(2) of Form N-1A; Item 9.1.c of Form N-2 (requiring the name, title, length of service of the person or persons primarily responsible for the day-to-day management of the fund's portfolio, together with each person's business experience during the last five years).

4 Instruction 2 to Item 5(a)(2) of Form N-1A and the Instruction to Item 9.1.c of Form N-2 require disclosure that a committee, team or other group of persons is primarily responsible for making the day-to-day management decisions of the fund, but not the names of the members of the group.

5 Proposal at 4. The disclosure would include the portfolio manager's name, title, length of service, business experience for the last five years, and his or her role on the management team (*e.g.*, lead member).

6 We also note that disclosure of individual members of a portfolio management team increases the likelihood of these individuals being solicited by competitors.

Accordingly, we ask the Commission to clarify that the term "jointly and primarily responsible" refers only to the individual members of a team or committee who are authorized to make final investment decisions for a fund's portfolio.[7] Additionally, we ask the Commission to clarify that a fund that has designated a "lead member" of a portfolio management team or committee need only provide the proposed information about the lead member in the fund prospectus. Such a clarification would focus the required disclosure on the information most important to investors.[8]

Importantly, we recognize that this clarification may not be appropriate for every type of portfolio management team. For example, we understand that certain teams (*e.g.*, that manage research-driven portfolios) are comprised of many individuals (*e.g.*, as many as 25 or more), each of whom has decision-making responsibility for a small percentage *(e.g.*, less than five) of a particular fund. Disclosure regarding each decision-maker under these circumstances would yield the unintended result of pages and pages of unhelpful disclosure for that particular fund. This issue merits further consideration and we recommend that the Commission consult with industry participants to find a practical solution.

The Commission also requests comment on whether the proposal should include additional information about portfolio management teams and their members, such as the team's structure and decision-making process.[9] We believe that the Commission has struck the right balance in this respect, primarily because additional information is not necessary and may increase the likelihood of detracting shareholders from more material information. As proposed, the requirements would permit an investment management firm to address further disclosure about the firm's decision-making process on an individual basis.

2. <u>Disclosure Regarding Other Accounts Managed, Potential Conflicts of Interest, and Policies and Procedures to Address Conflicts</u>.

The proposal would require a fund to provide in its Statement of Additional Information (SAI) information regarding other accounts for which the fund's portfolio manager is primarily responsible for the day-to-day management and any potential conflicts of interest that may arise in connection with the management of such accounts. The fund would also be required to provide a description of the policies and procedures used by the fund or the fund's adviser to address such conflicts. The disclosure would include the total number of other accounts, the total assets in the accounts, and the number of accounts and

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7 Proposed Instruction 2 to Item 5(a)(2) of Form N-1A and the Instruction to Item 9.1.c of Form N-2 appear to require the disclosure of each member of a portfolio team, regardless of the individual's responsibilities. The proposed language reads "If a committee, team, or other group of persons associated with an investment adviser of the [Fund] is jointly and primarily responsible for the day-to-day management of the [Fund]'s portfolio, information in response to this Item is required for each member of such committee, team, or other group."

8 In the event the final amendments do require disclosure of members of a portfolio management team that are not authorized to make final decisions for a fund's portfolio, we would recommend requiring disclosure about such individuals in the SAI.

9 Proposal at 5.

total assets for which the adviser receives a performance-based fee.[10] This proposal would require the disclosure of applicable accounts by every member of a portfolio management team, including accounts managed by another portfolio management team that include an overlapping member of the fund's portfolio management team.[11]

The ICAA commends the Commission for proposing disclosure that is designed to enable investors to assess the conflicts of interest to which a portfolio manager may be subject as a result of managing a fund and other portfolios. The proposed disclosure is an appropriate approach to mitigating conflicts of interest that are inherent in managing different types of accounts. While concurring with the approach, we recommend several clarifications to the proposal that we believe will result in more meaningful disclosure.

First, consistent with our prior comment, we suggest the proposed disclosure apply only to the individual members of a portfolio management team that are authorized to make final investment decisions for a fund's portfolio, and include only accounts for which that portfolio manager also has final investment decision-making authority.

Second, the proposal would require funds to describe any "conflicts of interest that may arise in connection with the [p]ortfolio [m]anager's management of the [f]und's investments on the one hand, and the investments of other accounts included [in the disclosure], on the other."[12] The ICAA strongly supports requiring the disclosure of conflicts of interest that result from a portfolio manager managing one type of account alongside another type of account. We are concerned, however, about the instructions to describe "any" conflicts that "may" arise. This broad terminology may cause funds to include lengthy lists of potential scenarios that could detract from actual material conflicts that exist. Accordingly, we ask the Commission to clarify the instructions to require disclosure of "material" conflicts of interest.[13]

Third, the proposal would also require a fund to either provide a description of its policies and procedures used to address conflicts of interest or to include a copy of the actual policies and procedures.[14] Given the potential for this requirement to overwhelm the

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10 Proposal at 5-6 (describing proposed Item 15(a) of Form N-1A, proposed Item 21.1. of Form N-2, and proposed Item 22(a) of From N-3). The term "accounts" would include registered and unregistered investment companies, other pooled investment vehicles, and other accounts. We note that the categories of "unregistered investment companies" and "other pooled investment vehicles" potentially overlap, and ask the Commission to clarify in the final release that each account need only be disclosed in one category.

11 Proposed Instruction 2 to Item 15(a) of Form N-1A and Item 21 of Form N-2 reads: "If a committee, team or other group of persons that includes the Portfolio Manager is jointly and primarily responsible for the day-to-day management of the portfolio of an account, the account should be included in responding to …this Item."

12 Proposed Item 15(a)(4) of Form N-1A and Item 21.d of Form N-2.

13 This clarification is consistent with an investment adviser's obligation to disclose conflicts of interest related to proxy voting. *See Final Rule: Proxy Voting by Investment Advisers,* SEC Release No. IA-2106; File No. S7-38-02 (Jan. 31, 2003) at Section II.A.2.b (requiring an adviser to have policies and procedures that address how the adviser resolves *material* conflicts of interest.) (emphasis added).

14 Proposed Item 15(a)(4) of Form N-1A and Item 21.d of Form N-2 and accompanying instructions.

disclosure document, we believe it would be preferable to require disclosure that the fund has policies and procedures (approved and periodically reviewed by the fund board of directors)[15] that are designed to address conflicts of interest. At most, the fund should be required only to briefly summarize the policies, similar to the anticipated brief summaries that will be provided by advisers in Form ADV, Part 2 when it is adopted.[16]

The Commission has requested comment on whether a portfolio manager of a fund should be prohibited from managing certain other types of accounts.[17] The ICAA does not believe such a ban is necessary to protect fund shareholder interests because the disclosure is sufficient as proposed and consistent with an adviser's current fiduciary duty to disclose material conflicts of interests in all aspects of the advisory relationship. Additionally, advisers are required to have in place policies and procedures addressing such conflicts as part of their compliance programs.[18] Fund boards will have the relevant information to determine whether an investment adviser's policies and procedures addressing conflicts are appropriate to protect fund shareholders from inequitable treatment. Most significantly, we are concerned that prohibiting portfolio managers from managing certain other types of accounts would likely harm fund shareholders by limiting the pool of talented portfolio managers that would be eligible for, and interested in, managing mutual funds.

3. Disclosure of Securities Ownership of Portfolio Managers

The proposal would require a fund to disclose in a tabular format in its SAI the dollar range of securities owned beneficially or of record by the fund's portfolio manager in the fund and in other accounts managed by an investment adviser of the fund, or by any person directly or indirectly controlling, controlled by, or under common control with an investment adviser or principal underwriter of the fund.[19] The dollar ranges would be similar to, but exceed the current requirements of disclosure of fund shares for directors[20] and would apply to the portfolio manager and his or her immediate family members.[21] The stated purpose of this

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15 Investment Company Act Rule 38a-1.

16 *See Proposed Rule: Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV,* Rel. No. IA-1862, File No. S7-10-00 (Apr. 5, 2000); Letter from ICAA General Counsel Karen L. Barr to SEC Secretary Jonathan G. Katz, submitting ICAA Supplemental Comments Regarding Proposed Amendments to Form ADV (May 24, 2001).

17 Proposal at 7.

18 *Compliance Programs of Investment Advisers and Investment Companies,* SEC Rel. No. IA-2204 (Dec. 17, 2003).

19 Proposed Item 15(c) of Form N-1A and Item 21.3 of Form N-2.

20 *Id.* The proposed highest dollar range (of over $1 million) exceeds the highest range (of over $100,000) currently applicable for fund directors. *Cf.* Instruction 4 to Item 12(b)(4) of Form N-1A; Instruction 4 to Item 18.7 of Form N-2.

21 *Id.* The instructions to these items define "immediate family member" to include the individual's spouse, children residing in the individual's household, and any dependent of the individual as defined in section 152 of the Internal Revenue Code.

requirement is to allow fund investors to assess conflicts of interests and to determine the extent to which a portfolio manager's interests are aligned with fund investors.[22] We concur with these goals of the proposed rule, but recommend the following modifications to enable the rule to better achieve these aims.

First, consistent with our prior comment, we suggest the proposed disclosure apply only to the individual members of a portfolio management team that are authorized to make final investment decisions for a fund's portfolio, and include only accounts for which that portfolio manager also has final investment decision-making authority.

Second, we are concerned that the proposed disclosure could provide an incomplete or inaccurate picture regarding a portfolio manager's personal investment strategy. For example, little or no investment in a fund may simply reflect a portfolio manager's interests in addressing a competing investment need (*e.g.*, payment of student loans or other family obligations) and differing investment objectives. We suggest that this item should include cautionary language discouraging investors from interpreting a portfolio manager's disclosed holdings in a fund necessarily to be indicative of his or her alignment with fund shareholders or confidence level in the fund.

Third, we fully support the use of dollar ranges as opposed to actual dollar amounts. However, we are concerned that the proposed dollar ranges may compromise the privacy interests of portfolio managers by providing too much information about the manager's net worth, and cause fund managers who do want not this information to become public to choose not to manage registered funds. Thus, we recommend using dollar ranges identical to those now required for fund directors.

The Commission indicates that the purpose for proposing an increase in dollar ranges for portfolio managers as compared with fund directors is to alert fund shareholders of "significant" levels of investments and to allow a comparison of the "relative stakes of the manager in different accounts."[23] We believe any investment of $100,000 or greater meets the threshold for "significance" and therefore that the current dollar ranges for fund directors appropriately address this concern. Further, depending on the circumstances, the relative stakes of the manager in different accounts may be more appropriately addressed as an aspect of material conflicts of interest in the "Other Accounts Managed" item of this section. Accordingly, we recommend that the "Ownership of Securities" section cross reference investors to the "Other Accounts Managed" section for more information about a portfolio manager's securities ownership interests in other accounts.[24] To avoid duplicative disclosure, this cross-reference would be in lieu of disclosure of other accounts in the "Ownership of Securities" section.

Finally, the Commission has requested comment on whether a fund should be required to disclose the percentage of a portfolio manager's net worth that is invested in the securities

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[22] Proposal at 8.

[23] Proposal at 9.

[24] See Proposed Item 15(a)(4) of Form N1-A and Item 21.1.d of Form N-2.

of the fund or other accounts.[25] We strongly believe that such a requirement is inappropriate and unnecessary. Similar to our concern over dollar ranges, we are concerned that such an invasion of privacy could deter talented portfolio manager from choosing to manage registered funds.

4. Disclosure of Portfolio Manager Compensation Structure

The proposal would require a fund to provide disclosure in the SAI regarding the structure of, and the method used to determine, the compensation of its portfolio managers. Specifically, the disclosure would require "a description of the structure of, and the method used to determine, the compensation received by a fund's portfolio manager from the fund, its investment adviser, or any other source with respect to management of the fund and any other account included by the fund in response to the proposed disclosure regarding other accounts managed by the portfolio manager."[26]

The ICAA supports this disclosure as proposed. In response to the Commission's request for comment, the ICAA does not believe that the disclosure of actual amounts of compensation received by portfolio managers is necessary or appropriate. However, we ask the Commission to provide further specific guidance on the definition and components of compensation required to be disclosed (*e.g.*, the extent to which they include health benefits or insurance policies).

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We commend the Commission for its thorough approach to addressing disclosure regarding portfolio managers. We would be pleased to work with the Commission to implement these initiatives and appreciate the opportunity to comment on the effects of the current proposal. Please do not hesitate to contact the undersigned or ICAA General Counsel Karen Barr to discuss any questions the Commission or its staff may have.

Sincerely,

Caroline Schaefer

Caroline Schaefer
Associate General Counsel

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

25 *See* Proposal at 10 (asking whether a fund should be required to disclose a percentage of a portfolio manager's net worth that is invested in securities of the fund or other accounts).

26 Proposal at 7-8. The proposed instructions provide the following examples of compensation: salary, bonus, deferred compensation, retirement plans and arrangements.

ICAA

June 11, 2004

Via Electronic Filing

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

Re: Concept Release: Securities Transactions Settlement, Release No. 33-8398; 34-49405; IC-26384; File No. S7-13-04

Dear Mr. Katz:

The Investment Counsel Association of America (ICAA)[1] appreciates this opportunity to respond to the Commission's concept release[2] on securities transactions settlement issues. We commend the Commission and its staff for issuing the concept release and giving all interested parties an opportunity to discuss the important issues outlined in the concept release.

We believe the *goal* of achieving same-day affirmation of trades (SDA) and/or shortening the current T+3 settlement cycle – both of which would require significant improvements and investments in automation and straight-through-processing (STP) – is laudable. However, we strongly believe that a *regulatory mandate* requiring SDA or shortening the current T+3 settlement cycle is not warranted by any objective cost/benefit analysis and that such regulations would be ill advised, counterproductive, costly, and difficult to implement and monitor. The better approach is to encourage the development of *market-driven initiatives* to promote advances in STP that ultimately will be embraced by the vast majority of market participants.

The ICAA previously has expressed a number of concerns to the Commission regarding a regulatory mandate shortening the settlement cycle to T+1.[3] As noted in our

[1] The ICAA is a non-for-profit association that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA's membership today consists of more than 300 firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. For more information, please visit www.icaa.org.

[2] *Concept Release: Securities Transactions Settlement*, Release No. 33-8398; 34-49405; IC-26384; File No. S7-13-04 (Mar. 11, 2004).

[3] *See Letter from David G. Tittsworth, ICAA Executive Director to The Honorable Harvey L. Pitt, Chairman, Securities and Exchange Commission* (Oct. 9, 2001); *Letter from David G. Tittsworth, ICAA Executive Director to The Honorable Harvey L. Pitt, Chairman, Securities and Exchange Commission* (Jan. 14, 2002). A copy of each letter is attached and incorporated herein.

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previous letters, the ICAA and representatives of its member firms have for some time participated in the so-called Buy-Side Committee organized by the Securities Industry Association (SIA), the association that represents broker-dealer firms. In addition, the ICAA has sponsored conferences designed to inform and educate investment advisory firms about such issues. In this vein, the ICAA believes that additional informational and educational efforts are desirable and necessary in order to build awareness, increase knowledge, and to gain additional input relating to STP issues. We strongly urge the Commission to use its resources and its public platform to encourage similar efforts in the future. Clearly, much more work needs to be done to ensure that investment advisory firms – including the thousands of smaller firms – understand issues related to STP. We believe that additional informational and educational efforts will – over time – help to promote and ultimately achieve the goals outlined in the concept release.

Following are a few issues that the ICAA urges the Commission to consider with respect to same day affirmation (SDA) and shortening the settlement cycle (for purposes of this comment letter, we will use the term "T+1" to encompass all proposals to shorten the current settlement cycle). Based on these and other considerations, the ICAA strongly opposes a regulatory mandate requiring SDA or T+1.

<u>There is no evidence that current settlement and confirm/affirm processes and the accompanying regulatory framework are broken.</u> The concept release correctly notes that the "implementation of a T+3 settlement cycle is widely viewed as a success, and the U.S. clearance and settlement system continues to be one of the safest and most reliable in the world."[4] The ICAA wholeheartedly agrees with this statement. The current clearance and settlement systems in the United States, including regulations governing such activities, are sound and effective. In fact, there are no major gaps or imminent threats that justify a regulatory overhaul of the current system. The current systems and accompanying regulatory framework, including the T+3 cycle, have clearly demonstrated their value in a wide variety of circumstances, including increased globalization of the securities industry, dramatic increases in U.S. trading volumes, and unforeseen catastrophic events such as the September 11, 2001 attacks. Throughout all of these diverse and extremely volatile circumstances, the current system has worked well. Accordingly, the concept release does not identify any systemic risks or any significant investor losses that would have been prevented had SDA or T+1 requirements been in place.

While it is certainly justifiable and appropriate to consider whether additional improvements can and should be made, we commend the Commission for recognizing that the current system is not broken. This reality should be considered carefully and given appropriate weight as the Commission balances the perceived need for any regulatory changes in this area. This is not to say that improvements cannot or should not be pursued. In fact, a number of financial services firms, including members of our organization, are engaged in a wide variety of activities to streamline and automate their processes in order to gain efficiencies and reduce errors. The ICAA strongly supports

[4] Release at 9.

these market-driven initiatives. However, we do not believe that current information supports the imposition of new and costly regulatory requirements at this time.

Faster is not necessarily better. An oft-repeated phrase is that "nothing good happens between trade and settlement." Similarly, the concept release states that it is "generally accepted that a substantial portion of the risks in a clearance and settlement system is directly related to the length of time it takes for trades to settle . . . [i]n other words, 'time equals risk.'"[5] These statements have an inherent appeal. However, they are at best misleading. The fact of the matter is that many good things happen between trade and settlement – specifically, that the vast majority of trades do in fact settle within the current T+3 framework. A recent analysis reached the same conclusion:

> There is an old adage that says nothing good can happen between execution and settlement date. While it is a catchy phrase, it is also patently wrong. Many vital risk management activities occur in the days between trade and settlement date: Trade obligations are netted, funding for settlement is arranged, and trading errors are detected and reconciled. The reason for a waiting period before buying a gun is to give the seller a chance to confirm that the buyer doesn't have a criminal history. As with guns, once the trade transaction is settled, it's too late.
>
> In a T+1 environment, risk is increased when an institution doesn't have time to correct internal posting errors that become costly external errors when trades actually settle. A T+3 environment also allows the foreign investor time to calculate net currency requirements and execute foreign exchange transactions on the morning of T+1, when rates are more attractive. In the haste to settle, custodians and brokers will be tempted to accept delivery of everything with the hope that they'll find the right account to post the securities. When they don't find one, expect a lot of trades to be reversed in the market, leading to both losses and profits.[6]

Speeding up the settlement cycle and/or confirm/affirm requirements will not necessarily result in a better system. In fact, some have suggested that such changes will actually increase operational risks for the markets.[7] Particularly considering all of the complexities of the U.S. markets – including the wide array of securities that can be bought and sold, as well as difficulties related to settlement involving non-U.S. exchanges – the current regulatory framework works well. It provides sufficient

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[5] Release at 8.

[6] *The Sequel to T+1: Will the SEC Mandate Operational Efficiency?* Tim Lind, TowerGroup (May 2004).

[7] "The move from T+3 to T+1 would decrease credit or settlement risk, but the question is whether this reduction is significant enough to justify the massive technology and other costs the industry would be forced to bear *and the increased operational risk it could subsequently face.* Indeed, if reducing risk associated with securities settlement is the industry's goal, there are better ways to go about it." (emphasis added) "*T+1: Settling for more – higher priorities than T+1.*" Andrew Tinney, Michael Patterson, and Reuben Khoo. Global Exchange (2002).

flexibility for identifying, addressing, and resolving a number of problems that may arise while at the same time protecting the interests of investors. Speeding up confirm/affirm requirements and/or shortening the settlement cycle will not necessarily result in greater efficiencies and reduced risks.

While market-driven initiatives during the past few years have yielded advances in STP, *neither SDA nor T+1 are achievable today for many types and classes of securities transactions*. Unless and until greater progress is made toward achieving STP on a broad scale, it would be unwise for the Commission to adopt new regulatory requirements that involve significant costs but do not produce demonstrable benefits for most market participants.

The costs associated with a regulatory requirement imposing SDA or T+1 are not justified. The concept release correctly states that "the Commission must determine whether benefits of establishing a shorter settlement justify the costs of implementing it."[8] Portions of the concept release clearly indicate that the Commission and its staff believe that SDA and/or T+1 will reduce risks associated with clearance and settlement. We believe, however, that any objective analysis of the evidence clearly indicates that the potential risk reductions have been overstated relative to the costs of mandating SDA and/or T+1. With respect to the risks associated with the current clearance and settlement system, we believe the following statements from an analysis on the subject are instructive:

> [T]he suggestion that eliminating two days from the settlement cycle will reduce settlement risk by 67% is fundamentally flawed. The risk arguments for T+1 consider the absolute value of outstanding settlements and the extra time for price divergence and counterparty default found in a T+3 environment. What is not considered by the theory that time equals risk is the actual probability of default of a given counterparty. The calculation of risk is far more complex than a linear calculation based on the number of days between execution and settlement. Risk is a function of how well capitalized the market participants are, the volatility in the underlying markets, the effectiveness of internal controls within the firm, the legal certainty provided by national securities regulations, the integrity of the settlement infrastructure, and how well they measure, manage, and remedy risk between participants.[9]

Based on these and other arguments, the authors of the analysis concluded as follows:

> T+1 is not currently a priority for the global securities industry and is unlikely to become a priority for the foreseeable future. . .

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[8] Release at 10.

[9] *T+1: Cost, Risk, Benefit, and Other Urban Legends,* Timothy Lind and Dushyant Shahrawat, TowerGroup (June 2002).

> [T]he United States has one of the most robust settlement infrastructures in the world. The strength and maturity of the infrastructure, combined with the legal certainty of US securities regulation, eliminate principal risk between market participants and provide an adequate remedy against nonperforming counterparties. . .
>
> [C]ounterparty risk is effectively mitigated by use of a central counterparty between dealers and that delivery vs. payment mechanisms between dealers and custodians provide finality of settlement of cash and securities.[10]

On the flip side, everyone is in agreement that achieving SDA/T+1 will involve very significant costs. Many knowledgeable observers have noted that implementation of these initiatives necessarily involve costly and fundamental changes for all major segments of the securities industry.[11] For example, the SIA Business Case Report published in July 2000 (cited in the concept release[12]) estimated costs of $8 billion in moving to T+1 and predicted future annual industry-wide savings of $2.7 billion. The report also noted that the anticipated costs and predicted future savings will not fall evenly across all types of market participants. Of obvious interest to the ICAA, the report estimated that asset managers as a whole will incur costs of $1.7 billion and could expect future annual benefits of $402 million, resulting in a "payback" period of approximately 4.2 years (compared to payback periods of 2 – 2.5 years for broker-dealers and custodians). We have previously expressed our view that the assumptions used in the report are fundamentally flawed with respect to the investment advisory profession and that it underestimates the costs that will be required of investment advisers while overstating expected benefits. The SIA assumed that the entire investment adviser industry consisted of 238 firms, broken down as follows: 21 firms with more than $200 billion in assets under management (AUM), 42 firms with AUM of $50 – 200 billion, and 175 firms with AUM of less than $50 billion (which SIA categorized as "small" advisory firms).

In fact, there are thousands of registered investment advisory firms. In a recent report published by the ICAA and National Regulatory Services,[13] we reported that there are 7,165 SEC-registered investment advisers that manage in excess of $25 million. Of

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[10] *Id.* at 1.

[11] For example, many knowledgeable observers have noted the difference between moving from T+5 to T+3 compared to moving from T+3 to T+1. The former essentially involved speeding up processes whereas the latter involves fundamental changes that require significant costs, the development of new or improved technologies, and the development of new protocols.

[12] Release at 14.

[13] *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* (May 2004). The report is derived from filings required by the SEC from registered investment advisers. A copy of the complete report is available on the ICAA web site: www.icaa.org.

these firms, *only 98 firms manage in excess of $50 billion and 7,067 firms manage less than $50 billion*. Clearly, the SIA report drastically understated the actual number of investment advisory firms. It also assumed that 70 percent of all "small" advisory firms (*i.e.*, firms that manage assets of less than $50 billion) would not need to make any investments in order to comply with a T+1 mandate. We certainly believe this is an erroneous assumption. In fact, the vast majority of investment advisory firms will incur one-time as well as ongoing costs in order to achieve either SDA or T+1.

We believe it is critically important for the Commission to understand that the vast majority of investment advisory firms are truly small businesses. Our recent report, for example, notes that there are 5,783 firms that manage more than $25 million but less than $1 billion in assets. Similarly, 5,683 SEC-registered entities reported that they employ 10 or fewer employees.[14] We strongly urge the Commission to take steps to examine the relative costs and benefits on the thousands of smaller investment advisory firms prior to considering regulations requiring SDA or T+1.

If SDA and/or T+1 would produce the benefits and efficiencies that their advocates have claimed, we submit that the vast majority of investment advisers would be willing to incur the necessary costs. To date, however, it is clear that neither SDA nor T+1 have proven their market worth for most investment advisory firms.[15]

Accordingly, we conclude that the costs of SDA and T+1 far outweigh any purported benefits for most investment advisory firms. While future innovations and developments may cause us to reevaluate this conclusion, we do not believe that it would be prudent for the Commission to impose broad and costly regulatory mandates based on the current reality. At a minimum, we strongly urge the Commission to conduct an appropriate cost/benefit analysis of the investment advisory profession *before* contemplating any major regulatory action such as mandating SDA or T+1.

Market-driven initiatives have produced improvements in STP. During the summer of 2002, SIA announced that it was re-directing its efforts away from conversion to T+1 toward straight-through-processing (STP), stating that, "The overall goal of SIA's earlier STP/T+1 program to convert from T+3 to T+1 settlement by 2005 has been replaced by a set of challenging straight-through processing goals to be accomplished over the next two years. . . This will result in significant benefits to firms and investors."[16] Last month, SIA iterated its commitment to STP efforts, noting that: "We

[14] *Id.* at 5 and 7.

[15] The same argument also applies to other market participants. One report, for example, underscored that a small percentage of brokerage firms had taken even the most basic of steps in preparing for T+1, finding that only 16 percent of brokerage firms had completed an inventory of processes, and 12 percent an inventory of affected applications. *T+1: State of the Industry.* Gartner, Inc. (D. Furlonger, T. Parker; Feb. 2002). Such information certainly begs the question: if T+1 and SDA will supposedly produce such dramatic benefits and efficiencies, why are so many firms reluctant to take the necessary steps and incur the costs that are required to achieve such desirable results?

will continue to work to gain the full support of all the industry for straight-through processing, buy side and retail, through communication and education. It's in our clients' best self-interest to automate."[17] The ICAA strongly supported SIA's decision to refocus its resources and efforts toward STP initiatives and we wish to take this opportunity to commend SIA again for the leadership role it has assumed in this important area. We strongly believe that SIA's decision in 2002 clearly underscores the need for the Commission to evaluate carefully whether it should impose requirements via regulatory fiat that the vast majority of market participants find to be costly and premature.

In fact, improvements in STP have occurred during the past two years. For example, in 2001 same-day affirmation rates were about 13 percent. Today, they are at about 23 percent. Similarly, the percentage of unaffirmed trades have declined from about 15 percent in 2001 to 12.8 percent today. The significance of these statistics is heightened when considering market conditions during the relevant time period. While these statistics show major improvement, they also demonstrate that the industry has a long way to go before SDA or T+1 can be accurately characterized as any type of prevalent industry practice – even among the more sophisticated firms. Certainly, the Commission at this time cannot justify imposing SDA and/or T+1 on the basis that such regulations are needed to "close the gap" in prevailing market practices.

The ICAA is aware of other market-driven initiatives that have been developed to provide incentives to the investment advisory profession (including smaller firms) for automating trade-related activities. For example, several major brokerage firms have worked with Omgeo to develop a product designed to automate allocation instructions between the investment adviser and the broker. As contemplated, the allocation manager product would be provided free of charge for investment adviser firms. We believe that these and similar market-driven initiatives ultimately will produce better results than a regulatory strait jacket. In fact, it is difficult to imagine that any such initiative would ever have been developed if the Commission had imposed SDA or T+1 via regulation.

A recent white paper[18] developed by the SIA STP Buy-Side Committee highlights the need for market-based efforts that emphasize an adequate return on investment rather than a regulatory mandate that will stifle innovation and impose significant costs. Based on interviews with a small sampling of diverse advisory firms, the paper recommends that the return on investment for buy-side firms should be improved in the following ways: (1) the SIA should revisit the concept of centralized matching to determine if it is essential in order to achieve the underlying industry STP goals; (2) allow market forces and not new regulations to drive the move to STP and the innovation in solutions that will drive costs down and improve benefits; and (3) the SIA should consider adjusting the

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[16] *SIA Board Endorses Program To Modernize Clearing, Settlement Processes for Securities,* SIA Press Release (July 18, 2002).

[17] *SIA Board Approves Continuation of STP Efforts,* SIA Press Release (May 5, 2004).

[18] *Buy-Side Straight-Through Processing White Paper,* SIA STP Buy-Side Committee (Dec. 2003). The white paper was cited in the SIA's recent press release as one of the most significant examples of progress in the STP arena during the past year.

scope of the STP program to include international securities, since the SIA has focused on domestic securities due to the de-emphasis of T+1 settlement.

The ICAA heartily endorses the recommendations set forth in the Buy-Side White Paper. Accordingly, we urge the Commission to refrain from imposing costly and unworkable regulations mandating SDA or T+1 and instead to foster market-driven initiatives to improve STP.

* * * * *

If SDA and/or T+1 will result in greater efficiencies, risk reduction, and a reasonable return on investment, there is no doubt that the various participants in the securities industry – including the investment advisory profession – will take steps to achieve these positive benefits. Based on market-driven initiatives, discernible improvements in STP have been achieved during the past 2-3 years and will continue in the future. While we believe that the goals of SDA and T+1 are commendable, we do not believe that a regulatory mandate is justified at this time, either in terms of the alleged benefits or the major costs involved. In fact, we believe that imposing SDA and/or T+1 at this time potentially may stifle innovations, reduce competition, and lead to increased operational risk.

The ICAA appreciates the opportunity to provide these comments and we stand ready to provide additional information to the Commission or its staff.

Respectfully,

David G Tittsworth

DAVID G. TITTSWORTH
Executive Director

Cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

ICAA

July 9, 2004

Via Electronic Filing

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

Re: Certain Thrift Institutions Deemed Not To Be Investment Advisers, Release Nos. 34-49639, IA-2232; File No. S7-20-04

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates this opportunity to comment on the proposed new rule[2] that would exempt certain thrift institutions from the Investment Advisers Act of 1940. As set forth below, we believe the proposed rule is inconsistent with the Commission's well-established views relating to functional regulation. Further, we do not believe that any compelling evidence has been demonstrated that would justify allowing thrift institutions to avoid regulation to which they are currently subject under the Advisers Act.

Background

Historically, the definition of "investment adviser" in section 202(a)(11) of the Advisers Act specifically has excluded all "banks" and "bank holding companies." Because of this exclusion, banks and bank holding companies conducting investment advisory activities generally have *not* been subject to Commission regulation and in fact are specifically excluded from the protections afforded to investors under the Investment Advisers Act.[3]

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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 more than 300 federally registered advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. Additional information about the ICAA is available on our web site: www.icaa.org.

[2] *Certain Thrift Institutions Deemed Not To Be Investment Advisers*, Release Nos. 34-49639, IA-2232; File No. S7-20-04 (Apr. 30, 2004).

[3] We believe the exclusion for banks and bank holding companies is at odds with the overarching goals of the Investment Advisers Act and inconsistent with the Commission's stated support for functional regulation. There is no compelling justification for excluding banks from the provisions and protections of the Advisers Act when bank activities fall squarely within the definition of "investment adviser" and when the bank (or some part thereof) is holding itself out as an investment adviser. The historic exclusion for

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The term "bank," however, does *not* encompass savings associations and other thrift institutions.[4] Therefore, thrift institutions historically have always been subject to Commission regulation under the Advisers Act if their activities fall within the definition of "investment adviser," *i.e.,* if they are engaged in the business of providing advice regarding securities to others for compensation.[5]

In 1999, Congress enacted the Gramm-Leach-Bliley Act.[6] Certain provisions of this law amended the Investment Advisers Act to require registration of banks and bank holding companies that serve or act as an investment adviser to a registered investment company.[7] Banks and bank holding companies that do not advise investment companies continue to be excluded from the definition of "investment adviser." Notably, the Gramm-Leach-Bliley Act did *not* change the application of the Advisers Act to thrifts.

Since enactment of Gramm-Leach-Bliley, the thrift industry has stepped up its efforts, urging the SEC, as well as Congress, to afford identical treatment to thrifts as banks for purposes of the Investment Advisers Act.[8] The requested exemption – and rationale therefore – was described in a speech delivered in 2001 by the Director of the SEC's Division of Investment Management:

> The Gramm-Leach-Bliley Act (GLB) contains a number of provisions that affect the investment management business. GLB amended various terms in both the Investment Company Act and the Investment Advisers Act, and gave the SEC new regulatory authority to enable the SEC to address issues presented by greater involvement of banks in the investment management business. For example, the Investment Advisers Act currently excludes banks from the definition of "investment adviser." GLB amended the definition of "investment adviser" to include a bank within the definition of investment adviser, if it acts or serves as an investment adviser to a registered investment company. A bank may register its

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banks and bank holding companies is best explained as the result of political and jurisdictional clout rather than substantive public policy.

[4] *See, e.g., Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Release No. 34-44291; File No. S7-12-01 (May 11, 2001)("Interim Final Rules") at n. 246.

[5] *See* Investment Advisers Act of 1940, § 202(a)(11). *See also, Investment Advisers Act Release No. 1092* (Oct. 8, 1987).

[6] Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[7] Investment Advisers Act, Section 202(a)(11).

[8] In fact, the issue of whether thrifts should be excluded from Advisers Act coverage has been previously raised by the thrift industry. For example, in 1983, the SEC issued a notice requesting comment on granting an exemption from the Advisers Act to thrifts. *Status of Savings and Loan Associations Under the Federal Securities Laws*, Rel. No. IC-13666, 49 Fed. Reg. 6383 (Dec. 19, 1983). After due consideration, however, the SEC did not take further action on the notice.

entire corporate structure as an investment adviser or it may choose to register only a separate division or department of the bank. Consequently, for the first time the SEC will be able to inspect bank advisers to registered investment companies. Previously, the Commission had authority only to inspect the registered investment company's records.

The Investment Company Act definition of "bank" was amended in such a way that now thrift institutions can sponsor common and collective trust funds, exempt from registration under the Investment Company Act. However, the definition of bank in the Investment Advisers Act was not amended to exempt thrifts from the Advisers Act. *We recognize that to place thrifts on a level playing field with banks regarding offering common and collective trust funds, that it seems appropriate to use our rulemaking authority to exempt thrifts from the Advisers Act, to the extent that they engage in bona fide fiduciary activity. Consequently, we have been working on an exemptive rule for thrifts in this area.*[9] (emphasis added)

We also note that the Commission issued interim final rules in 2001 that provide exemptions for banks, savings associations, and savings banks under the Securities Exchange Act of 1934.[10] The rules grant an exemption from the definitions of "broker" and "dealer" for savings associations and savings banks on the same terms and conditions that banks are excepted or exempted from broker-dealer registration.

Issues and Concerns

While we recognize that the Commission has attempted to draft a rule that is tailored to specific activities conducted by thrifts, we nonetheless conclude that the proposed rule is contrary to legislative provisions and Congressional intent, will create an ill-advised loophole under the Advisers Act contrary to functional regulation, will result in unfair competition among thrifts and registered investment advisers, and will open the door to other ill-advised exemptions from the Investment Advisers Act – all without any justifiable or compelling public benefit.

1. *The proposed rule for thrifts is not consistent with provisions of the Gramm-Leach-Bliley Act.* When Congress passed the Gramm-Leach-Bliley Act (GLB Act), it amended various provisions of the securities laws, including the Investment Advisers Act of 1940. As noted in the Commission's proposed exemption for banks, savings associations, and savings banks, the GLB Act was landmark legislation that marked the culmination of more than three decades of deliberation.[11] In revising numerous

[9] "Managing the Revolution," Keynote Address of Paul F. Roye at the Third Annual Compliance Summit sponsored by the ICAA and *IA Week*, Washington, D.C. (Mar. 26, 2001). *See also*, Keynote Address of Paul F. Roye at the Glasser LegalWorks Fifth Annual Investment Advisor Compliance Conference, New York, New York (May 4, 2001).

[10] Interim Final Rules, *supra* note 4.

[11] Interim Final Rules, *supra* note 4, at 5-6.

provisions of the securities laws, Congress had more than ample opportunity to consider an exemption for thrifts similar to that enacted for banks under the Advisers Act. In fact, the GLB Act explicitly amended the definition of "investment adviser" in section 202(a)(11) of the Advisers Act to require registration of banks that serve as advisers to investment companies. Yet the final legislation is silent with respect to thrifts. If Congress had intended to grant similar treatment of thrifts as with banks, it could have done so.[12] We respectfully submit that the Commission should not substitute its judgment on policy issues that were the subject of extensive Congressional deliberations and final action. In effect, the Commission now is proposing to deal with issues that already have been settled by Congress.

2. *The proposed rule is inconsistent with functional regulation and will create an unwise loophole.* Significantly, Congress *added* banking entities to the Commission's jurisdiction in enacting the GLB Act in order to achieve more functional regulation. Under the GLB Act, Congress for the first time subjected banks that advise mutual funds to investment adviser regulation and for the first time subjected banks to broker-dealer regulation with a number of exceptions. These provisions addressed Congressional concern that banks had been permitted "to engage in securities activities without being subject to the provisions of the federal securities laws that were designed to protect investors."[13] Granting the proposed exemption for thrifts from the protections of the Advisers Act will create an unnecessary and potentially troublesome gap in regulatory coverage under the Advisers Act. Such an approach also is contrary to the Commission's longstanding support for functional regulation, as well as the GLB Act's endorsement of functional regulation.[14]

3. *The proposed rule will create an unlevel playing field for investment advisers and thrift institutions.* The primary argument in support of the proposed rule by the thrift industry is that an exemption from the Advisers Act is necessary to create a level playing field between banks and thrifts. We are concerned, however, that the exemption instead may create an unlevel playing field between thrifts and investment advisers. By exempting certain thrift activities from registration and regulation under the Advisers Act, the Commission would allow thrifts to engage in essentially identical activities as investment advisers while avoiding the regulatory structure of the Advisers Act. As

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[12] *See AmeriFed Federal Savings Bank* no-action letter (pub. avail. Jan. 18, 1990). In *AmeriFed*, the SEC staff refused to grant relief from the securities laws to a savings bank wishing to maintain a collective trust fund, stating "[n]or do we believe that we should, by administrative interpretation, eliminate the distinction that Congress has drawn in the federal securities laws between banks and thrifts." Congress – not the Commission – subsequently changed the *AmeriFed* result in the Gramm-Leach-Bliley Act.

[13] Interim Final Rules, *supra* note 4, at n. 22-23 and accompanying text.

[14] "The GLBA codified the concept of functional regulation – that is, regulation of the same functions, or activities, by the same regulator, regardless of the type of entity engaging in those activities. Congress believed that, given the expansion of the activities and affiliations in the financial marketplace, functional regulation was important to building a coherent financial regulatory scheme." Interim Final Rules, *supra* note 4, at 16.

noted in the Commission's interim rule exempting banks, savings associations, and savings banks from provisions of the Exchange Act:

> The federal securities laws provide a comprehensive and coordinated system of regulation of securities activities. They are specifically and uniquely designed to assure the protection of investors through full disclosure concerning securities and the prevention of unfair and inequitable practices in the securities markets. *The securities laws also have as a goal fair competition among all participants in the securities markets.*[15] (emphasis added)

Creating an exemption for thrifts – albeit a limited exemption – may unfairly disadvantage investment advisers that are subject to registration and regulation under the Investment Advisers Act. Investment advisers owe a fiduciary duty to their clients, are required to comply with various statutory and regulatory restrictions, and are subject to rigorous oversight by the Commission.[16] Exempting thrifts from requirements of the Advisers Act may enable them to perform the same functions as investment advisers while remaining outside of the legal and regulatory scheme Congress has mandated and may result in an unfair competitive advantage for thrift institutions.

For example, under the proposed rule, thrifts will be allowed to manage collective trust funds without being subject to the provisions and protections of the Advisers Act.[17] We believe this is a vivid case in point of a situation where a thrift is clearly engaging in activities that fall within the Advisers Act, where the protections of the Advisers Act are appropriate and necessary, and where granting an exemption creates a clear disparity between thrifts and other investment advisers.

4. *There is no compelling public or investor protection benefit that justifies the proposed exemption for thrifts from Advisers Act registration and regulation.* The rationale that has been advanced to support the thrift exemption is that banks and thrifts should be treated the same. However, this rationale does not amount to a compelling public or investor protection benefit that justifies the Commission's proposed rule. The Commission is charged with the protection of investors. Granting an exemption to thrifts from Advisers Act registration and regulation under certain circumstances potentially may harm investors because thrifts will not be subject to the panoply of legal and regulatory requirements governing the investment adviser profession.[18] For example, one

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[15] Interim Final Rules, *supra* note 4, at 16-17.

[16] For a discussion of issues related to the Investment Advisers Act, *see* Statement of David G. Tittsworth, Executive Director, Investment Counsel Association of America, Inc., *SEC Roundtable on Investment Adviser Regulatory Issues* (May 23, 2000).

[17] The proposing release states that the proposed rule "would except a thrift institution from the Advisers Act to the extent it provides investment advisory services to its collective trust funds that are excepted from the definition of 'investment company.'" Release, at 8.

[18] For example, in our comment letter on the pending rule regarding the broker-dealer exception under the Advisers Act, we noted that there are at least four aspects of the Advisers Act and accompanying laws that differ significantly from those governing broker-dealers: fiduciary duty, restrictions on principal trading,

of the most significant investor protections in the Advisers Act is the requirement that advisers provide their clients *prior to or at the time of* engagement a brochure that describes the adviser's business, services, fee structures, and all material actual or potential conflicts of interest.[19] In addition, extensive information about the business, services, and disciplinary history of each SEC-registered investment adviser must be filed electronically and is then made publicly available by the SEC.[20] We know of no similar requirements currently required of thrift institutions under any provision of law or legal theory.

5. *The proposed rule opens the door to other ill-advised exemptions from the Investment Advisers Act.* We submit that adopting the proposed exemption for thrifts constitutes a slippery slope that potentially could erode investor protection by narrowing the reach of the Investment Advisers Act. If the Commission approves the proposal, arguably it will be easier for other entities to claim that the protections of the Advisers Act should not apply to them. For example, we note that certain commenters already have urged a significant expansion of the proposed exemption for thrifts, arguing that the scope of the exception also should "include thrifts when they act as agent for accounts that have a fiduciary purpose."[21] We believe an exemption of this magnitude is clearly unwarranted and would result in a potentially wholesale avoidance of the important investor protections provided under the Advisers Act for entities that fall within the definition of "investment adviser."

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disclosures, and prohibition of testimonials. *See* Letter to Jonathan G. Katz from David G. Tittsworth, ICAA Executive Director re: Release Nos. 34-42009; IA-1845; File No. S7-25-99; *Certain Broker Dealers Deemed Not To Be Investment Advisers* (Jan. 12, 2000). Such aspects, as well as a desire to avoid the costs of complying with Advisers Act regulation, may be relevant to the proposed rule relating to thrifts.

[19] Investment Advisers Act, Section 204 and Rule 204-3 thereunder.

[20] *See* www.adviserinfo.sec.gov, the SEC's web site that posts all current Form ADV, Part 1 filings by investment advisers.

[21] *See Letter from Christian G. Heilmann, Merrill Lynch Trust Company, FSB to Jonathan Katz* (June 25, 2004). The letter urges the Commission to expand the proposed thrift exemption in other ways, *e.g.* by including *all* revocable trusts in the category of accounts having a fiduciary purpose, and eliminating the requirement that thrifts covered by the Advisers Act must make available for examination all trust department records and not just those pertaining to the covered accounts.

For the foregoing reasons, we urge the Commission to reject the proposed rule. We would be pleased to discuss this matter with you or Commission staff and trust that you will not hesitate to contact us if we may provide any additional information to you regarding this or any other matter of mutual concern.

Sincerely,

DAVID G. TITTSWORTH
Executive Director

Cc: The Hon. William H. Donaldson
The Hon. Cynthia A. Glassman
The Hon. Harvey J. Goldschmid
The Hon. Paul S. Atkins
The Hon. Roel C. Campos
Paul F. Roye

ICAA

August 12, 2004

Via Electronic Filing

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

Re: Proposed Rule: Limitations on Affiliate Marketing (Regulation S-AM); Release Nos. 34-49985; IC-26494; IA-2259; File No. S7-29-04

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to comment on the Commission's proposed Regulation S-AM[2] implementing certain limitations on affiliate marketing, as mandated by the Fair and Accurate Credit Transactions Act of 2003 (FACT Act).[3]

The proposal would require that if federally registered investment advisers[4] communicate "eligibility information"[5] (also referred to as "information") of a consumer[6] to

[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 350 federally registered advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. Additional information about the ICAA is available on our web site: www.icaa.org.

[2] *Proposed Rule: Limitations on Affiliate Marketing (Regulation S-AM)*; Release Nos. 34-49985; IC-26494; IA-2259; File No. S7-29-04 (Jul. 8, 2004) (proposal), as published in 69 FR 42302 (Jul. 14, 2004) (Release).

[3] Pub. L. No. 108-159, § 214, 117 Stat. 1952 (2003). The FACT Act amended the Fair Credit Reporting Act (FCRA), 15 U.S.C. 1681-1681x.

[4] Proposed Regulation S-AM applies to brokers, dealers, investment companies, investment advisers registered with the Commission and transfer agents registered with the Commission. We comment only with respect to federally registered investment advisers.

[5] "Eligibility information" incorporates the concept of "consumer report" in the FCRA and is defined as "any information the communication of which would be a consumer report if the exclusions from the definition of 'consumer report' in section 603(d)(2)(A) of the FCRA did not apply." Proposed 17 CFR 247.3(i); Release at 42318. It may include any information bearing on a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living, whether that information was obtained from a person's own transactions or experiences with the consumer (*e.g.*, information about a

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the adviser's affiliate,[7] the affiliate may not use the information to make or send marketing solicitations to the consumer, unless prior to such use by the affiliate: (1) the adviser provides clear and conspicuous notice to the consumer that the information may be communicated to and used by the adviser's affiliate to make or send marketing solicitations to the consumer about the affiliate's products and services; (2) the adviser provides the consumer a reasonable opportunity and a simple method to "opt out" of the affiliate's use of the information; and (3) the consumer has not chosen to opt out. The proposal provides for several exceptions from the opt-out notice requirements.[8]

The ICAA commends the Commission and its staff for issuing such a thorough proposal in the short time period provided by Congress. We support the Commission's effort to implement rules in compliance with the FACT Act to protect a consumer's right to restrict marketing solicitations made to them by the company's affiliate based on certain information received by the affiliate. However, we request that the Commission clarify and modify proposed Regulation S-AM: (A) to conform the definitions of "affiliate" and "consumer" to Regulation S-P's definitions; (B) to clarify that the opt-out notice is triggered only by the adviser's affiliate using the eligibility information of the adviser's consumers to make or send marketing solicitations; (C) to clarify the ability of an adviser to include affiliates' marketing solicitations in the adviser's periodic statements or other communications to consumers; (D) to permit the use of oral notice and opt-outs; and (E) to provide a 15-month compliance date for the rule.

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consumer's account history with that person) or from other sources (*e.g.*, information received from credit bureau reports). Release at 42306.

[6] "Consumer" is defined as "an individual." Proposed 17 CFR 247.3(f); Release at 42318.

[7] An "affiliate" of an adviser is "any person that is related by common ownership or common corporate control with the" adviser. In addition, an adviser will be deemed an affiliate of a company if: (1) that company is regulated under Section 214 of the FACT Act by a government regulator other than the Commission; and (2) rules adopted by the other government regulator under Section 214 of the FACT Act treat the adviser as an affiliate of that company. *See* Proposed 17 CFR 247.3(a); Release at 42318. The term "person" under the proposal means "any individual, partnership, corporation, trust, estate, cooperative, association, government or governmental subdivision or agency, or other entity." Proposed 17 CFR 247.3(o); Release at 42319. *See also* 15 U.S.C. 1681a(b) (same definition in the FCRA).

[8] Under the proposal's exceptions, the notice and opt-out sections of Regulation S-AM do not apply if the affiliate uses eligibility information it receives from an adviser: (1) to make or send a marketing solicitation to a consumer with whom the affiliate has a pre-existing business relationship (as defined in the proposal); (2) to facilitate communications to an individual for whose benefit the affiliate provides employee benefits or other services pursuant to a contract with an employer related to and arising out of the current employment relationship or status of the individual as a participant or beneficiary of an employee benefit plan; (3) to perform services for another affiliate; (4) in response to a communication initiated by the consumer orally, electronically, or in writing; (5) in response to an affirmative authorization or request by the consumer orally, electronically, or in writing to receive a marketing solicitation; or (6) if the adviser's or affiliate's compliance with the notice and opt-out requirements would prevent it from complying with state insurance laws relating to unfair discrimination in any state in which the entity is doing business. Proposed 17 CFR 247.20(c); Release at 42319-20.

A. <u>Definitions</u>

We support consistency in the proposal with Regulation S-P,[9] which implemented Title V of the Gramm-Leach-Bliley Act of 1999[10] and which has the same general policy goals as Regulation S-AM of protecting consumer information. The proposed definition of "clear and conspicuous"[11] is the same as the definition in Regulation S-P.[12] Entities subject to Regulation S-P, such as investment advisers, have significant experience with privacy notices, which enables them to understand how to satisfy the clear and conspicuous standard so that notices are understandable to consumers. In addition, the proposed definition of "control"[13] is similar to the definition of control in Regulation S-P.[14] Thus, we believe these proposed definitions are sufficient.

The proposed definition of "affiliate,"[15] however, is not consistent with the definition of "affiliate" in Regulation S-P.[16] Due to the fact that varying definitions of the same terms will cause unnecessary burdens and complexities, we strongly urge the Commission to ensure consistency to the maximum extent possible. Accordingly, we request the Commission amend the proposed definition of "affiliate" in Regulation S-AM to be more consistent with the definition of "affiliate" in Regulation S-P.[17]

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[9] *See* 17 CFR 248.1 - 248.30.

[10] 15 U.S.C. 6801-6831 (GLB Act).

[11] The proposal defines clear and conspicuous as "reasonably understandable and designed to call attention to the nature and significance of the information presented." Proposed 17 CFR 247.3(c); Release at 42318.

[12] *See* 17 CFR 248.3(c)(1). Moreover, Regulation S-P provides examples of "clear and conspicuous" after the definition. *See* 17 CFR 248.3(c)(2).

[13] "Control" of a company is proposed to be defined as "the power to exercise a controlling influence over the management or policies of a company whether through ownership of securities, by contract, or otherwise. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percent of the voting securities of any company is presumed to control the company. Any person who does not own more than 25 percent of the voting securities of any company will be presumed not to control the company. Any presumption regarding control may be rebutted by the evidence, but, in the case of an investment company, will continue until the Commission makes a decision to the contrary according to the procedures described in section 2(a)(9) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(9))." Proposed 17 CFR 247.3(g); Release at 42318.

[14] *See* 17 CFR 248.3(i).

[15] *Supra* note 7.

[16] *See* 17 CFR 248.3(a).

[17] We recommend the Commission define "affiliate" of an adviser as "any person that controls, is controlled by, or is under common control with the . . ." adviser. *See* 17 CFR 248.3(a) (Regulation S-P definition of "affiliate").

We further request that the Commission clarify the definition of "consumer" so that it more closely tracks the definition in Regulation S-P.[18] The obligations for financial institutions to provide privacy notices and affiliate marketing opt-out notices should not differ based upon the definition of consumer. As proposed, consumer means an individual.[19] However, to follow the definition in Regulation S-P more closely, the Commission could adopt a definition of consumer such as, "an individual whose eligibility information derives from accounts, products or services used for personal, family or household purposes, or that person's legal representative."[20] This definition would exclude, for example, sole proprietorships, which do not have the same characteristics as a natural person. In order to further standardize the definition, we recommend the Commission include the same examples that accompany the definition of consumer in Regulation S-P in its definition of consumer for Regulation S-AM.[21]

B. Triggering Event for Opt-Out Notice Requirements

The proposal generally makes clear that the triggering event for the opt-out notice requirement is the adviser's affiliate using the eligibility information of the adviser's consumer to make or send marketing solicitations to the consumer. The FACT Act and the proposed rule do not establish, nor should the final rule establish, opt-out notice requirements merely when an adviser shares eligibility information with its affiliates. This distinction is important because a financial institution may share information related to its customers with its affiliates for any number of important business reasons other than for marketing purposes. For example, a financial institution may share information with an affiliate in order to: conduct research and analysis about products, services, or customers; evaluate demographic information about customers; and better understand customers to become a more efficient provider of financial services.

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[18] Under Regulation S-P, "consumer means an individual who obtains or has obtained a financial product or service from you that is to be used primarily for personal, family, or household purposes, or that individual's legal representative." 17 CFR 248.3(g)(1).

[19] Proposed 17 CFR 247.3(f); Release at 42318.

[20] The FACT Act defines "consumer" to have the same meaning as in Section 603 of the FCRA, which defines consumer as an individual. However, the FACT Act specifically authorizes the Commission to "prescribe regulations to implement section 624" of the FCRA, as amended by the FACT Act. In crafting rules pursuant to this specific authority, the Commission has proposed definitions that contain minor, non-substantive changes from various legislative provisions. In doing so, the Commission has recognized that such changes are necessary to achieve consistency and to avoid confusion. For example, although the FACT Act defined "affiliate" to mean persons that are related by common ownership or affiliated by common control, the Commission proposed a more lengthy and detailed definition in Regulation S-AM. *See* Pub. L. No. 108-159, § 214, 117 Stat. 1952 (2003); Proposed 17 CFR 247.3(a); Release at 42318. In addition, the Commission proposed a definition of marketing solicitation that "tracks the definition in Section 624 of the FCRA, [but] it does not follow the statute exactly." Release at 42306. The Commission noted that, "[m]odifications are intended to prevent confusion in the context of the federal securities laws." *Id.* We submit that the modifications we have requested are necessary for the same reasons.

[21] *See* 17 CFR 248.3(g)(2). For example, under Regulation S-P, an individual is not a consumer solely because he or she is a beneficiary of a trust for which an adviser is a trustee. *See* 17 CFR 248.3(g)(2)(vii).

However, language in the proposal and the proposed rule seem to suggest that an adviser sharing eligibility information with an affiliate, without the affiliate using it to make or send marketing solicitations, may trigger the opt-out notice requirements. Accordingly, we request the Commission adopt clarifying language in the following areas.

First, the proposal states, "[t]he requirements of notice and opt-out would only apply if a receiving affiliate uses eligibility information for marketing purposes."[22] However, the following sentence notes that, "[t]hus, the requirements [to send notice by the adviser (the entity with whom the consumer has the relationship)] would not apply if no eligibility information is communicated to affiliates, or if no receiving affiliate uses eligibility information to make marketing solicitations."[23] This could imply that the notice and opt-out requirements *would* apply if eligibility information were simply communicated to an affiliate, without the affiliate using the information to make marketing solicitations. We request the Commission clarify this inconsistency in the final adopting release.

Second, and more importantly, we request the language in the proposed rule itself be clarified. Specifically, we request the Commission to revise the proposed "rules of construction" described in proposed 17 CFR 247.20(a)(2)(ii) [24] to align the rules more closely with the intent of the FACT Act. We suggest the following clarifying language:

> (ii) *Avoiding duplicate notices*. If Affiliate A communicates eligibility information about a consumer to Affiliate B, and Affiliate B communicates that same information to Affiliate C who plans to make marketing solicitations, Affiliate B does not have to give an opt-out notice to the consumer prior to Affiliate C's use, so long as Affiliate A's notice is broad enough to cover Affiliate C's use of the eligibility information to make marketing solicitations to the consumer.

This language would more closely align that section with the example rule of construction contained in 17 CFR 247.20(a)(2)(iii), which provides that "the rules of construction would (A) Permit B to *use the information to make marketing solicitations* . . ." (emphasis added).[25]

C. <u>Advisers Providing Affiliate Marketing Information</u>

As discussed above, the FACT Act does not prohibit the sharing of eligibility information among affiliates. The statute is intended to cover direct marketing communications by an affiliate that does not have a direct relationship with the consumer.

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[22] Release at 42307.

[23] *Id.*

[24] Proposed 17 CFR 247.20(a)(2)(ii) (*Avoiding duplicate notices*) provides that, "If Affiliate A communicates eligibility information about a consumer to Affiliate B, and Affiliate B communicates that same information to Affiliate C, Affiliate B does not have to give an opt-out notice to the consumer *when it provides eligibility information to Affiliate C*, so long as Affiliate A's notice is broad enough to cover Affiliate C's use of the eligibility information to make marketing solicitations to the consumer." (emphasis added).

[25] Release at 42319.

Section 214 of the FACT Act states that the affiliate "may not use the [eligibility] information [it received] to make a solicitation for marketing purposes to a consumer about its products or services"[26] without providing the notice and opt-out. Accordingly, we do not believe the proposed opt-out notice requirements should apply if an adviser includes an affiliate's marketing material along with the adviser's periodic statements or other communications (*e.g.*, web sites, newsletters, etc.).[27] This activity is not covered or contemplated by the FACT Act. Thus, Regulation S-AM should not prohibit any marketing of the products or services of an adviser's affiliate merely because it may be included in the adviser's periodic statements or other communications. As discussed above, the triggering event for Regulation S-AM requirements, as mandated by the FACT Act, is an *affiliate's* making or sending marketing solicitations on the basis of the consumer-specific eligibility information that the affiliate received. Implementing a different rule would be inconsistent with the FACT Act and the intent of Congress.

The Commission seeks comment on whether, and to what extent, various tools used in Internet marketing, such as pop-up ads, could constitute marketing solicitations as opposed to communications directed at the general public.[28] An adviser's or its affiliate's advertisement on the adviser's Internet web site that "pops up" alongside the display of information about the consumer's relationship with the adviser is being provided by the adviser, much in the same manner that the adviser may choose to place information about its affiliate's product as a "statement stuffer." In this case, the adviser would be providing a service to its clients regarding the adviser's or its affiliate's available products and services. This is distinguishable from an affiliate using the consumer's eligibility information to make or send a marketing solicitation directly to the consumer. Moreover, the definition of "marketing solicitation" requires the marketing be "initiated by" the adviser's affiliate.[29] Therefore, marketing conducted by the adviser is not governed by Section 214 of the FACT Act and should not be covered by the proposed rules.

In addition, the Commission seeks comment on whether certain Internet marketing tools could constitute marketing solicitations as opposed to communications to the general public.[30] The rules governing electronic, Internet communications with a consumer should not vary dramatically from those governing written communications. Thus, pop-up

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[26] *Supra* note 3.

[27] The Commission notes that, "Proposed paragraph (a) would not apply if, for example, a financing company affiliated with a broker-dealer asks the broker-dealer to include financing-company marketing materials in periodic statements sent to consumers by the broker-dealer without regard to eligibility information." Release at 42307.

[28] Release at 42306.

[29] Marketing solicitation means marketing initiated by an adviser's affiliate to a particular consumer that is: (i) based on eligibility information communicated to the affiliate by the adviser; and (ii) intended to encourage the consumer to purchase or obtain a product or service. Proposed 17 CFR 247.3(n); Release at 42319.

[30] Release at 42306.

advertisements should be considered “marketing solicitations” only if they fall into the proposed definition.[31]

D. Oral Notice and Opt-Out

The proposal permits the opt-out notice to be provided to a consumer in writing or, if the consumer agrees, electronically.[32] The Commission requests comment on whether oral notice and opt-out should be permitted.[33] The ICAA believes that oral notice and opt-out should be permitted for affiliate marketing notices.[34] The goals sought by the requirements governing written or electronic requirements could be satisfied by an adviser using a standard script and/or a “frequently asked questions” (FAQ) script to provide the requisite notice to the consumer and permit him or her to opt-out at that time. A script and/or FAQ could meet the definition of “clear and conspicuous” as long as it is reasonably understandable and calls attention to the nature and significance of the information presented in person or on a telephone call. A one-on-one meeting or telephone call between a consumer and an adviser’s representative may be even more likely to assist a consumer in understanding the substance of the affiliate marketing rules because the consumer has the ability to ask questions and provide verbal responses. Any methods used by the adviser to track oral opt-outs could be easily implemented in way similar to those methods used to track written or electronic opt-outs.

E. Effective Date and Mandatory Compliance Date

The Commission seeks comment on “what the mandatory compliance date should be and whether it should be different from the effective date of the final rules in order to permit institutions to incorporate the affiliate marketing notice into their next annual GLB Act privacy notice.”[35] We believe the Commission should allow for a longer compliance period than the effective date in order to help institutions incorporate their affiliate marketing notices into their next privacy notices and to reduce costs. We respectfully request the Commission implement a compliance date that is at least 15 months after the regulation’s publication date. For Regulation S-P, the Commission implemented a compliance date 12 months after the publication date, which was reasonable given that Regulation S-P required financial institutions to implement their notice requirements for the first time and coordination with other federally mandated notices was not necessary. However, for Regulation S-AM, some advisers undoubtedly will have already delivered their privacy notices by the time the final Regulation S-AM is published this year. Moreover, other advisers may be mailing their annual privacy notice shortly after the publication date of Regulation S-AM and would not have a meaningful opportunity to incorporate their affiliate marketing notice into their privacy

[31] Marketing solicitation does not include communications that are directed at the general public without regard to eligibility information. Release at 42306.

[32] Release at 42308.

[33] *Id*.

[34] We recommend that such provisions and examples be added to Proposed 17 CFR 247.22(b), 17 CFR 247.23(a), and 17 CFR 247.24(b).

[35] Release at 42309.

notice. With only a one-year compliance date, the affiliate marketing compliance date would expire by the time the next privacy notice would be due under the adviser's normal schedule. Thus, advisers would need a period longer than one year to coordinate their affiliate marketing notice into their next privacy notice.

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For all of these reasons, we respectfully request that the Commission clarify and/or modify the proposal as discussed. We appreciate your consideration of our comments and would be pleased to work with the Commission to implement our suggestions or to provide additional information. Please do not hesitate to contact the undersigned or ICAA General Counsel Karen Barr to discuss any questions the Commission or its staff may have.

Sincerely,

Monique S. Botkin
ICAA Counsel

cc: The Hon. William H. Donaldson
The Hon. Cynthia A. Glassman
The Hon. Harvey J. Goldschmid
The Hon. Paul S. Atkins
The Hon. Roel C. Campos

Paul F. Roye, Director, Division of Investment Management

ICAA

September 14, 2004

Via Electronic Delivery

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

Re: Registration under the Advisers Act of Certain Hedge Fund Advisers: Rel. No. IA-2266; File No. S7-30-04

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates this opportunity to provide comments on proposed rule 203(b)(3)-2 and corresponding amendments under the Investment Advisers Act of 1940, which would require investment advisers to hedge funds[2] to register with the Commission under the Advisers Act.[3] This letter supplements our prior comments submitted in response to the Hedge Fund Roundtable conducted before the Commission in May 2003.[4] The ICAA supports the Commission's proposal to require registration of hedge fund advisers.

As discussed in our Roundtable Letter, the ICAA recognizes the benefits hedge funds offer to eligible investors by providing an effective alternative investment strategy that may reduce portfolio risk, as well as the important role hedge funds can play in contributing to the overall efficiency of our marketplace.[5] We believe that hedge funds

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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 approximately 350 SEC-registered investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of institutional and individual clients. See www.icaa.org for more information.

2 The term "hedge fund" is not defined under the federal securities laws and has no precise legal definition. The term generally refers to an unregistered pooled investment, privately organized, not advertised, and administered by professional investment managers, whose securities are privately placed with wealthy individual and institutional investors. *See generally* Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission at 3 (Sept. 2003).

3 *Registration Under the Advisers Act of Certain Hedge Fund Advisers*: Rel. No. IA-2266; File No. S7-30-04 (July 20, 2004) (proposal).

4 *Letter to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, from David G. Tittsworth, Executive Director of the Investment Counsel Association of America, Re: Comments on the Hedge Fund Roundtable, File No. 4-476* (July 7, 2003) (Roundtable Letter).

5 Roundtable Letter at 3.

play an important role in the global financial services marketplace. Accordingly, we applaud the Commission for issuing a proposal that does not interfere with or impede innovation and strategies that have characterized the hedge fund industry.

We concur with the Commission's conclusion that more information is needed about hedge funds and their managers. Registration of hedge fund advisers will allow the Commission to gain a better understanding of the industry and enable the Commission to identify any problems before they develop. In addition, investors and the marketplace will benefit from the disclosure, compliance protocols, recordkeeping, and regular examination requirements that will accompany registration of hedge fund managers.

We offer our additional comments and suggestions in response to the proposal below for the Commission's consideration.

1. Definition of Private Fund

Section 203(b)(3) of the Advisers Act currently exempts hedge fund managers from registration under the Advisers Act that have 14 or fewer clients and do not hold themselves out generally to the public as an investment adviser.[6] As discussed in the proposal, the Commission has historically permitted an adviser to treat a limited partnership as the "client" for purposes of this exemption if, among other things, the advice provided to the limited partnership is based on the investment objectives of the partnership rather than those of each limited partner.[7]

The proposal would eliminate this exemption for hedge funds by requiring an adviser to a "private fund" to count each owner of the fund as a client for purposes of determining the availability of the private adviser exemption of section 203(b)(3) under the Advisers Act.[8] We believe this "look through" to the underlying investors for purposes of determining an adviser's obligation to register is appropriate. As discussed in the Roundtable Letter, we strongly agree with the approach in the proposal that the "look through" should be limited to the narrow purpose of requiring hedge fund manager registration.[9]

A "private fund" generally is defined under proposed section 203(b)(3)-2(d)(1) as a fund that: (1) relies on exemption 3(c)(1) or 3(c)(7) under the Investment Company Act of 1940 to avoid registration under the Investment Company Act; (2) permits its owners

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[6] This exemption is referred to as the "private adviser" exemption.

[7] *See* proposal at 36 (discussing the adoption of Advisers Act Rule 203(b)(3)-1 and related commentary).

[8] *See* proposed rule 203(b)(3)-2.

[9] Roundtable Letter at 6.

to redeem some portion of their ownership interests within two years of purchase; and (3) is offered based on the investment advisory skills, ability, or expertise of the adviser.[10]

The proposal includes an exemption to this definition for a "private fund" that: (1) is located outside the United States; (2) made a public offering of its securities outside the United States; and (3) is regulated as a public investment company outside the United States.[11] An adviser would not be required to look through funds that have these characteristics to count the individual underlying investors.

We support the definition of "private fund" and its corresponding exemption as proposed. In response to the Commission's specific request for comment,[12] we also support as proposed: (1) applying the current asset under management structure (under which advisers with 25 million dollars or more in assets under management are eligible to register with the SEC) to all advisers; and (2) the two-year lock-up period.

2. Offshore Advisers and Funds

The proposal would require an adviser that is located outside of the United States (an offshore adviser) to look through the funds the adviser manages to count U.S. investors as clients, regardless of the location of the fund. An offshore adviser that manages a fund comprised of 14 or more U.S. investors (or other advisory clients) would generally be required to register under the Advisers Act,[13] regardless of the amount of assets under management attributable to U.S. investors. However, under the proposal the Commission would permit an offshore adviser to a fund located outside the United States (an offshore fund) to treat the fund as a client for all purposes under the Advisers Act, other than (1) determining the availability of section 203(b)(3); and (2) the provisions prohibiting fraud.[14]

We believe that the requirement for registration under the Advisers Act should turn on the number of U.S. investors, and that the amount of assets under management attributable to U.S. investors is a secondary consideration. We also agree with the proposal's aim of limiting the extraterritorial application of the Advisers Act to offshore funds. Accordingly, we strongly support as proposed the Commission's approach to the regulation of offshore advisers and offshore funds.

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10 *See* proposal at 89.

11 Proposed Section 203(b)(3)-2(d)(3).

12 Proposal at 40 and 49.

13 As discussed in the proposal, if no other exemption is available, the adviser would be required to register regardless of its assets under management, because the $25 million threshold does not apply to advisers that do not have a U.S. principal place of business (Proposal at 42 and accompanying notes).

14 Proposal at 44 (discussing the applicability of *Uniao de Banco de Brasileiros S.A.*, SEC Staff No-Action Letter (July 28, 1992) under such circumstances).

3. Performance Records

The Advisers Act requires an adviser to maintain certain documents to support the firm's performance claims for a period of five years after the performance information is last used.[15] The proposal would permit a new registrant to retain whatever information the firm has to support the performance earned prior to registration under the Advisers Act, and would excuse the firm from fulfilling the specific requirements of rule 204-2 for the period before becoming registered.[16]

We understand the importance of permitting hedge fund managers to preserve their performance history. However, this interest must be balanced against the potential to mislead investors. As a solution, we suggest that registrants that cannot fulfill the requirements of rule 204-2 be required to include a legend on any advertisement that alerts investors that the firm has not maintained records supporting performance calculations for the period in question.

4. Qualified Clients and Performance Fees

Rule 205-3 currently permits registered advisers to charge performance fees only to "qualified clients" and requires the adviser to a fund exempt from registration under section 3(c)(1) of the Investment Company Act to look through the fund to determine whether all investors are qualified clients.[17] As discussed in the proposal, although many managers of hedge funds require investors to meet the criteria of a qualified client, many do not. The proposal would amend rule 205-3 to avoid requiring hedge fund investors to divest their current interests in a fund because they do not meet the definition of "qualified client." The amendment would permit current investors that are not qualified clients to retain their existing investments in that fund and to add to that account.

We agree it would be unfair to the particular investors and disruptive to markets generally to require investors who are not qualified clients to divest from their funds, and therefore strongly support this aspect of the proposal. However, we recommend limiting this exemption to current accounts and prohibiting an investor that is not a qualified client from opening a new account or investing in other accounts managed by the same adviser that charge performance fees.

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15 *See* Advisers Act Rule 204-2(a)(16).

16 Proposal at 51.

17 Advisers Act Rule 205-3(a) and (b). In order to qualify as a "qualified client" an investor must generally place a minimum of $750,000 under management with a particular adviser or have a net worth of $1.5 million.

5. CFTC Registration

In a dissent to the proposal, Commissioners Glassman and Atkins specifically request comment on whether there should be an exemption to registration under the Advisers Act for advisers that are registered with another government agency.[18] We do not necessarily believe that registration under the Advisers Act should be required for managers that are registered as commodity pool operators (CPOs) or commodity trading advisers (CTAs) under the Commodity Exchange Act (CEA) with the Commodity Futures Trading Commission (CFTC). Registered CPOs and CTAs are subject to disclosure and recordkeeping requirements, as well as to examinations by the National Futures Association (NFA),[19] and we are not aware of any evidence to suggest that the CFTC reporting requirements and the NFA examination process is insufficient to provide proper regulation of these entities.

Requiring the dual registration of a hedge fund manager with the CFTC and the Commission would impose an unnecessary, additional layer of regulation on the manager and therefore may be an unjustifiable commitment of Commission resources. In response to the Commission's concern that amendments to the CEA may allow advisers to avoid registration,[20] we recommend that the Commission provide an exemption from registration under the Advisers Act only to hedge fund managers that are actually registered as CPOs or CTAs with the CFTC and subject to NFA examination.

6. Costs Associated with Registration under the Advisers Act

Finally, we must take issue with the statements in the proposal that the burdens of registration under the Advisers Act are "minimal" and the costs associated with registration "would not be high."[21] Registered advisers incur considerable costs in their commitment to fulfilling their fiduciary obligations under the Advisers Act. The dissent correctly notes that registration under the Advisers Act is meaningful and carries with it substantive requirements[22] including: compiling and updating Form ADV,[23] developing

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18 Dissent to the proposal at 110.

19 Proposal at 34-35; *See also Testimony of Patrick J. McCarty, General Counsel of the Commodity Futures Trading Commission before the U.S. Senate Committee on Banking, Housing and Urban Affairs* (July 15, 2004) (stating that CPOs and CTAs are inspected generally on an average of every 2.5 to 3 years for compliance with CFTC recordkeeping, disclosure, and reporting requirements).

20 Proposal at 35 and accompanying notes.

21 Proposal at 31, 63 (estimating the costs to establishing a compliance infrastructure to be "$20,000 in professional fees and $25,000 in internal costs including staff time").

22 Dissent to the proposal at 104-05.

23 We note that Form ADV will provide many details about hedge fund advisers that are needed to address concerns about the hedge fund industry. Part 1 of Form ADV provides much more than "a census of name, address, and amount of assets under management" (see dissent to proposal at 101). Part 1 provides, among other things, information about clients, other business activities of

and overseeing proxy voting policies and procedures, establishing and implementing a compliance program designed to prevent violations of the securities laws, and developing and enforcing a code of ethics.[24] The new investment adviser compliance program rule alone has resulted in significant, additional costs for many investment advisory firms. The rule, which was unanimously approved by the Commission, will result in fundamental changes in investment adviser compliance activities and will require a substantial expenditure of time, effort, and resources by all investment advisory firms. On one hand, we believe it is inconsistent to argue that the proposed hedge fund rule should not be adopted due to the significant costs involved, when the Commission has unanimously voted to impose such costs on all investment advisory firms, including the thousands of advisory firms that are small businesses.[25] On the other hand, we disagree with the claim that the costs of adviser registration and compliance are relatively inconsequential and thus will not pose any burden for hedge fund advisers. The fact is that investment adviser registration and compliance have become increasingly complex and costly.

Despite these costs, the relative risks involved with many hedge fund activities, as compared to many investment advisory activities, clearly justify the imposition of investment adviser registration and compliance requirements for hedge fund advisers. The fact that an increasing number of hedge fund managers already are voluntarily complying with the Advisers Act registration and regulatory requirements would appear to support the conclusion that such requirements do not present inappropriate obstacles to hedge fund management. We also note that the costs associated with registration under the Advisers Act have been borne by thousands of small investment advisers; we believe that hedge fund advisers are in at least an equal, if not better position to bear these costs.

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We commend the Commission for the thoughtful and deliberate approach taken to the issue of registration of hedge fund managers. Please do not hesitate to contact our organization if we can be of any further assistance.

Sincerely,

David G. Tittsworth
Executive Director

Caroline Schaefer
Associate General Counsel

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the adviser, financial industry affiliations, limited partnerships and limited liability companies for which the adviser serves as a general partner or manager, participation or interest in client transactions, custody of client assets, control persons, and financial and disciplinary issues.

[24] *See* Form ADV Part 1 and II, and Advisers Act rules 206(4)-6, 206(4)-7, and 204A-1.

[25] *Evolution Revolution: A Profile of the Investment Advisory Profession* (May 2004) at 6 (finding that 50% of registered advisory firms reported having between one and five employees, and that 68.5% reported having ten or fewer employees).

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

ICAA

September 22, 2004

Via Electronic Filing

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

Re: Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release Nos. IA-2278, 34-50213; File No. S7-25-99

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit supplemental comments on proposed rule 202(a)(11)-1 under the Investment Advisers Act of 1940.[2]

The proposed rule is intended to address the application of the Advisers Act to brokers offering their customers full-service brokerage, including investment advice, for an asset-based fee instead of traditional commissions, mark-ups, and mark-downs. Under the proposed rule, a broker-dealer providing investment advice to customers, regardless of the form of compensation, would be excluded from the definition of investment adviser as long as: (1) the advice is provided on a non-discretionary basis; (2) the advice is solely incidental to the brokerage services; and (3) the broker-dealer discloses to its customers that their accounts are brokerage accounts. The rule would also prevent a broker-dealer providing advice to customers from being subject to the Advisers Act solely because it also offers execution–only brokerage services at reduced commission rates.

The ICAA applauds the Commission for moving to address this rule proposal, which has been pending for nearly five years. The proposal involves issues that are of fundamental

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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 350 investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

2 *Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Release Nos. IA-2278, 34-50213; File No. S7-25-99 (Nov. 4, 1999) ("Proposal"). The comment period was re-opened on August 18, 2004.

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importance to investors, as well as to the investment advisory profession and the brokerage industry. In light of many profound changes that have occurred in recent years, we strongly believe the Commission needs to clarify the distinctions between advisory and brokerage accounts. In doing so, we urge the Commission to consider the issue from the viewpoint of an investor and to craft a rule – including appropriate disclosures – that will enable investors to make informed decisions about the types of services and products that are being provided.

During the initial comment period, the ICAA expressed concern that the proposed rule fails to give appropriate and definitive guidance regarding the circumstances under which a broker will have to treat an account as an advisory account.[3] We subsequently joined with other trade and consumer organizations to discuss serious problems with the rule as proposed,[4] as well as to express disagreement with the no-action position taken by the Commission pending final rule adoption.[5] We incorporate these letters by reference and take this opportunity to highlight our most significant concerns and to respond to the Commission's additional requests for comment.

All Discretionary Accounts Should Be Treated Consistently.

The Commission's proposed rule focuses primarily on the "nature of the services provided," rather than on the form of compensation charged, to determine whether an account is an advisory account or a brokerage account. We concur that a functional test that examines whether the services provided are advisory in nature is appropriate. Functional regulation is consistent with the Commission's position that "the same rules should apply to the same activities in the financial marketplace – particularly when the rules are designed to protect investors."[6]

Rather than examining each type of arrangement to determine whether the services provided are advisory in nature, or delineating factors that would lead to such a determination,

[3] Letter from David G. Tittsworth, ICAA Executive Director, to Jonathan G. Katz, Secretary, SEC, re: Release Nos. 34-42009; IA-1845; File No. S7-25-99*: Certain Broker-Dealers Deemed Not To Be Investment Advisers* (Jan. 12, 2000).

[4] Letter from Consumer Federation of America (CFA), Certified Financial Planner Board of Standards (CFP Board), ICAA, and National Association of Personal Financial Advisors (NAPFA) to Jonathan G. Katz, Secretary, SEC, re: Release Nos. 34-42009; IA-1845; File No. S7-25-99: *Certain Broker-Dealers Deemed Not To Be Investment Advisers* (May 31, 2000); Letter from CFA, Fund Democracy, ICAA, Financial Planning Association, CFP Board, and NAPFA to the Honorable William Donaldson, Chairman, SEC (May 6, 2003).

[5] "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 discretion as subject to the Act." Proposal at 4.

[6] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization and H.R. 10, the Financial Services Competition Act of 1997, before the House Committee on Commerce, Subcommittee on Financial and Hazardous Materials (July 17, 1997). *See also Final Rule: Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934,* SEC Rel. No. 34-47364; File No. S7-41-02 (Feb. 13, 2003) (endorsing functional regulation).

the Commission attempts to provide a bright line test based on whether investment advice is provided on a discretionary basis. We agree with the Commission that by their very nature, discretionary accounts "bear a strong resemblance to traditional advisory accounts, and it is highly likely that investors will perceive such accounts to be advisory accounts."[7] This makes it all the more puzzling why the Commission would carve out from this bright line test discretionary accounts that are charged commissions. A broker has full authority to buy and sell securities in a discretionary account without the investor's prior consent to each transaction. A commission-based discretionary account should invoke *greater* investor protection concerns because of the potential incentive for a broker to churn the account without consultation with the investor on a transaction-by-transaction basis.

In deciding to eliminate "special compensation" as a factor in this analysis, the Commission obviously determined that the form of compensation should not be the deciding factor in determining whether an account is an advisory account. It offers no justification from departing from that principle in providing a loophole for discretionary accounts charging commissions.[8] We urge the Commission to treat *all* discretionary accounts as advisory accounts.

The Commission Should Clarify What It Means by "Solely Incidental."

The Commission should clarify what constitutes "solely incidental" advice by a broker. Historically, distinctions were drawn between brokerage and advisory accounts based principally on special compensation, while the "solely incidental" prong of the test was virtually ignored. If the Commission continues to provide no meaningful guidance regarding the term "solely incidental," this purported condition will essentially be eliminated from the exemption.

In the proposing release, the Commission emphasizes that in offering asset-based fees, brokers are simply "re-pricing" traditional brokerage services. The Commission must define what these traditional brokerage services are. Clearly, brokerage services include executing transactions and providing custodial and recordkeeping services. Traditionally, registered representatives have also provided periodic or intermittent advice with respect to particular securities being considered by the investor or that the broker recommends for consideration by the investor. We believe that such advice is part of traditional brokerage services and should continue to be considered to be solely incidental to such services.

On the other hand, portfolio management, selection of portfolio managers, and asset allocation services, even where performed on a non-discretionary basis, should not be

[7] Proposal at 10.

[8] The Commission could also avoid such an anomalous result by considering the alternative offered by the Consumer Federation of America (CFA). The CFA has suggested a theory under which new forms of compensation could be accommodated under the existing broker-dealer exemption, section 202(a)(11)(C). *See* letter dated January 13, 2000 to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Barbara L. N. Roper, Consumer Federation of America (CFA letter).

considered to be solely incidental to brokerage transactions.[9] Such services are core investment advisory services that should be subject to the fiduciary protections of the Advisers Act.[10] We respectfully request that the Commission confirm that these core investment advisory services are not solely incidental to traditional brokerage services.

Broker-Dealers Relying on the Rule Should Not Be Permitted to Market Advisory Services Prominently.

We strongly urge that the rule prohibit a broker-dealer claiming an exclusion from the Advisers Act from marketing accounts primarily based on the quality of advisory services provided. In the proposed rule, the Commission noted that broker-dealers offering fee-based advisory services have heavily marketed them and that this "raises troubling questions as to whether the advisory services are not (or will be perceived by investors not to be) incidental to the brokerage services."[11] This marketing of advisory services - which may use testimonials from customers that would not be permitted for advisory accounts - has not abated in the past five years. It is clearly misleading for a broker-dealer to market its advisory services prominently while at the same time avoiding responsibilities and duties under the Advisers Act by claiming that such services are "solely incidental" or a minor component of the brokerage services offered. An investor responding to such marketing materials would undoubtedly expect the account offered to be an advisory account.

The Proposed Disclosure Should Be Enhanced.

The Commission requests comment on whether prominent disclosure that an account is a brokerage account is sufficient to alert an investor to the nature of the account. Such disclosure is not merely insufficient, but woefully inadequate. Virtually all commenters to the proposal, even strong proponents of the proposal, agreed that disclosure that an account is a brokerage account "does not provide sufficient information to customers."[12] Where a broker-dealer provides advice that is not subject to the Advisers Act, the disclosure needs to be clear and phrased in a manner that can be readily understood by a typical investor. The broker must delineate the implications of an account being a "brokerage account" and the solely

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[9] For example, the Commission may wish to consider the factors used in determining accounts over which the broker exercises "continuous and regular supervisory or management services" for purposes of Form ADV. The instructions to Item 5F of Part 1A of Form ADV indicate that a firm does not provide continuous and regular supervisory management to an account if the firm provides advice on a periodic or intermittent basis, such as in response to a client request or market event. On the other hand, a firm does exercise such management if it has ongoing portfolio management responsibility even on a non-discretionary basis.

[10] The Commission has already recognized that such functions are core advisory functions in requiring sponsors of wrap fee programs to treat wrap fee accounts as advisory accounts. *See* Proposal at 12. *See also* NASD Regulation: Fee-Based Account Questions and Answers ("Wrap accounts typically include services such as asset allocation and portfolio management for a fixed fee. Most wrap accounts with these features are subject to the Advisers Act").

[11] Proposal at 11.

[12] Letter dated Jan. 13, 2000 from Jean Margo Reid, Chair, Investment Adviser Committee, Securities Industry Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission.

incidental nature of the advice provided. For example, the Commission could require *prominent* disclosure along the following lines:

1. [Name of broker-dealer] is a registered broker-dealer. Our primary business is executing securities transactions.[13]
2. The accounts and services described here are *not* subject to the Investment Advisers Act of 1940 because we believe that any investment advice we provide is solely incidental to our primary/brokerage business.[14]
3. As such, [name of broker-dealer] provides advice only on a periodic basis or at your request and does not undertake a duty to manage your account on an ongoing and continuous basis.[15]

Indeed, the Commission may also wish to consider requiring full disclosure of conflicts of interest and any disciplinary history. These are critical disclosures under the Advisers Act for the protection of investors. Even investors receiving "incidental" advice should be entitled to these disclosures.

The Commission Should Consider the Interests of Investors.

The Commission requests comment regarding whether current fee-based programs more closely align the interests of investors with those of brokerage firms and their registered representatives than do traditional commission-based services. In a fiduciary environment of professional investment managers, fees based on assets under management do align the interests of the client with the interests of the firm. This may not necessarily be the case, however, in a sales-based culture. In citing the need for this rule, the Commission relies on the Tully Report,[16] which indicated that fee-based programs might be a best practice for brokers because they reduce the "incentives for registered representatives to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics."[17] However, as the NASD has noted, the Tully Report also indicated that fee-based compensation programs might not suit the needs of investors with low trading activity.[18] Indeed, the NASD has detected potential problems with respect to brokers' fee-based accounts, including:

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[13] Alternatively, the disclosure could state that the firm is acting as a broker-dealer and not as an investment adviser with respect to the account.

[14] Similarly, the CFA suggests disclosure that "any advice being offered is solely incidental to sales transactions" and that the registered representative "is not subject to a requirement that the salesperson place the client's interest ahead of his or her own." CFA letter at 10.

[15] The broker should be required to identify the duty it has undertaken with respect to these accounts, whether fiduciary or otherwise, both in its marketing and its contracts with customers. A non-discretionary account holder should not be lead to believe that the broker is continuously supervising the account and proactively alerting the customer to market, economic, issuer or other changes that require action, if the broker has not taken on that overarching fiduciary duty.

[16] Report of the Committee on Compensation Practices (Apr. 10, 1995) ("Tully Report").

[17] Proposal at 6.

[18] NASD Notice to Members 03-68 (Nov. 2003).

- Customers may not be receiving adequate disclosure about the distinctions and features of fee-based versus commission-based accounts, including that fees probably will be higher in a fee-based account if trading activity is modest;
- Training and education regarding these programs is “minimal” at some firms;
- Firms do not always have systems in place to reasonably ensure that mutual funds and other products are not inappropriately switched into a fee-based account;
- Some firms may lack systems or procedures to ensure a fee-based account is appropriate for the customer both initially and periodically thereafter; and
- Most troubling, “in some instances firms have not assigned a broker to customers with fee-based accounts.”[19]

The Commission should consider these potential problems in crafting a rule that ensures appropriate functional regulation of advisory services and best protects investors.

CONCLUSION

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

Sincerely,

David G. Tittsworth

David G. Tittsworth
Executive Director

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

[19] NASD Regulation: Fee-Based Account Questions and Answers (last updated Aug. 23, 2004).

ICAA

October 20, 2004

Via Electronic Filing

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

Re: Proposed Rule: Disposal of Consumer Report Information; Release Nos. 34-50361; IA-2293; IC-26596; File No. S7-33-04

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to comment on the Commission's proposed amendments to the safeguard rule[2] under Regulation S-P[3] that implement the provision in the Fair and Accurate Credit Transactions Act of 2003 (FACT Act)[4] requiring proper disposal of consumer report information and records.[5]

The proposal would require that registered investment advisers[6] properly dispose of consumer report information or any compilation of consumer report information for a business purpose by taking reasonable measures to protect against the unauthorized access to

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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 350 federally registered advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. Additional information about the ICAA is available on our web site: www.icaa.org.

[2] 17 C.F.R. § 248.30.

[3] 17 C.F.R. §§ 248.1 - 248.30 (implementing Title V of the Gramm-Leach-Bliley Act of 1999, 15 U.S.C. 6801-6831).

[4] Pub. L. No. 108-159, § 214, 117 Stat. 1952 (2003). The FACT Act amended the Fair Credit Reporting Act (FCRA), 15 U.S.C. 1681-1681x.

[5] *Proposed Rule: Disposal of Consumer Report Information*, SEC Rel. Nos. 34-50361; IA-2293; IC-26596; File No. S7-33-04 (Sept. 14, 2004) (Proposal).

[6] In addition to registered advisers, the proposed amendments would apply to brokers and dealers (other than notice-registered broker-dealers), investment companies, and registered transfer agents.

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or use of the information in connection with its disposal (the disposal rule).[7] The proposal also would require that the policies and procedures that protect customer information under Regulation S-P's safeguarding rule (the safeguard rule) be in writing.[8]

The ICAA supports the Commission's effort to implement rules in compliance with the FACT Act to protect consumer report information and customer information. However, we write to request that the Commission: (1) revise the proposed definition of "consumer report information" in the disposal rule; (2) refrain from proposing to amend the safeguard rule to require specific elements, such as those elements required by the Federal Trade Commission's safeguard rule (FTC rule);[9] and (3) adopt a compliance date of 180 days for the proposed amendments.

1. Proposed Definition of "Consumer Report Information"

The Commission proposed to define "consumer report information" to mean "any record about an individual, whether in paper, electronic or other form, that is a consumer report or is derived from a consumer report."[10] The Commission seeks comment about the proposed definition, including whether it should be further clarified.[11]

We believe the definition could be written more precisely to confirm that "information that is derived from consumer reports but does not identify any particular individual would not be covered under the proposed rule."[12] As the Commission noted in the Proposal, "[l]imiting 'consumer report information' to *information that identifies particular individuals* is consistent with current law relating to the scope of the term 'consumer report' under section 603(d) of the FCRA and with the purposes of section 216 of the FACT Act." (emphasis added).[13] While we understand the Commission may have sought to express this concept by including the reference to a record "about an individual," we believe the definition could more clearly achieve consistency with the FCRA. Accordingly, we respectfully request the Commission amend the definition of "consumer report information" to mean "any record ~~about~~ <u>that personally identifies</u> an individual, whether in paper, electronic or other form, that is a consumer report or is derived from a consumer report." The phrase "personally identifies" more clearly indicates that consumer report information must identify a particular individual than does the phrase "about an individual."

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[7] Proposed 17 C.F.R. § 248.30(b)(2).

[8] Proposed 17 C.F.R. § 248.30(a).

[9] *See* Proposal at p. 9; *see also*, 16 C.F.R. §§ 314.3(a), 314.4 (FTC rule).

[10] Proposed 17 C.F.R. § 248.30(b)(1)(ii).

[11] Proposal at p. 4.

[12] *Id.*

[13] *Id.*

2. Elements for Safeguard Rule

The Commission requests comment on whether it should propose to amend the safeguard rule to require certain elements.[14] We respectfully submit that an amendment to require specific elements of an adviser's safeguarding program is unnecessary in light of (1) the Commission's proposal that safeguard policies and procedures be written, and (2) the new compliance program rule, rule 206(4)-7 under the Investment Advisers Act of 1940.

First, the Commission is proposing to require that policies and procedures under the safeguard rule must be written.[15] Written policies and procedures will help ensure protection for customer records and information. Documenting policies and procedures should assist those advisers whose policies and procedures are not currently written to satisfy their obligations under the safeguard rule.[16]

Second, the compliance program rule obligated advisers by October 5, 2004 to implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or its supervised persons. The SEC has construed this rule to include policies and procedures to safeguard the privacy protection of client records and information under Regulation S-P.[17] Therefore, the written safeguarding policies and procedures advisers implement and maintain will receive the benefit of the compliance program rule.

The compliance program rule requires that an adviser's chief compliance officer administer and enforce the firm's compliance policies and procedures. An adviser's policies and procedures should be designed to prevent violations from occurring, to detect violations that did occur, and to correct these violations promptly.[18] As the Commission noted, this should include testing and assessing the effectiveness of policies and procedures.[19] In addition, the compliance program rule requires advisers to conduct an annual review to

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[14] Proposal at p. 9.

[15] *Supra* n. 8; Proposal at p. 8. The safeguard rule requires advisers to adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. The policies and procedures must be reasonably designed to: (a) insure the security and confidentiality of customer records and information; (b) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (c) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer. 17 C.F.R. § 248.30.

[16] The Commission notes that its examinations of large organizations found that the organizations already have written safeguard policies and procedures in place that "generally address procedures at several levels, going from an organization-wide policy statement down to detailed procedures addressing particular controls." The Commission further noted that this "comprehensive approach to safeguarding is consistent with widely accepted standards adopted by government and private sector standard-setting bodies and professional literature and generally leads to reasonable policies and procedures." Proposal at p. 8.

[17] *See Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, SEC Rel. Nos. IA-2204; IC-26299; File No. S7-03-03 (Dec. 17, 2003) at n.21 and accompanying text.

[18] *Id*. at p. 5.

[19] *Id.* at n. 15.

evaluate the adequacy and effectiveness of their policies and procedures. This should include considering all policies and procedures, including those regarding safeguarding customer information, in response to any compliance matters, material business changes, or other appropriate circumstances that might suggest a need to revise the policies and procedures.[20] These requirements are comparable to the elements specified in the FTC rule (*e.g.*, designating a responsible employee, assessing risks, testing controls, and evaluating the program).

There is no evidence that any additional regulatory requirements are necessary, nor any basis to believe the safeguard and compliance rules together are insufficient to achieve the objectives sought. Thus, we respectfully request that the Commission refrain from proposing specific, required elements to be included within the adviser's safeguard rule. Rather, the Commission should evaluate the effectiveness of the newly implemented compliance rule, in conjunction with the requirement for written policies and procedures under the safeguard rule, to determine whether the flexibility provided by the compliance rule achieves the Commission's objectives.

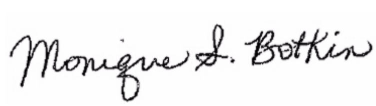
3. Compliance Date

We noticed the Commission did not propose a date by which compliance with the proposed amendments to Regulation S-P would be required. Advisers need a meaningful opportunity to analyze and evaluate how the disposal rule requirements will be worked into their current compliance program, including evaluating whether and how the rule applies to their current business practices. Therefore, we respectfully request the Commission adopt a compliance date 180 days from the date the adopting release is published in the Federal Register.

* * *

We appreciate your consideration of our comments and would be pleased to provide any additional information. Please do not hesitate to contact the undersigned or ICAA General Counsel Karen Barr to discuss any questions the Commission or its staff may have.

Sincerely,



Monique S. Botkin
ICAA Counsel

[20] *Id.* at p. 10.

November 19, 2004

Mr. Paul F. Roye, Director
Division of Investment Management
Ms. Lori A. Richards, Director
Office of Compliance Inspections and Examinations
Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549-0506

Dear Paul and Lori:

We are writing to reiterate our support for needed clarification of the Commission's expectations as to investment advisers' retention, production, and surveillance of e-mail.[1] As you know, during the past several months, we have expressed our concerns to Commissioners and staff about these important issues. We are heartened by reports that the Commission intends to issue guidance in order to apprise investment advisory firms of their specific legal obligations in this area. This letter is intended to assist in that effort by highlighting some of our concerns and outlining suggestions for clarifications. Going forward, we certainly would welcome the opportunity to discuss these issues in greater detail with you and your colleagues.

The issue of e-mail retention has become a prominent topic for investment advisers since the fall of 2003, when regulators discovered e-mails reflecting questionable activities in mutual fund trading. These scandals prompted SEC examiners to begin requesting the production of e-mail during investment adviser examinations as a routine matter. Today, it is common practice during SEC inspections of investment advisers for the examiners to request that all firm e-mail or all e-mail to or from certain individuals be produced promptly in an electronically searchable format. In addition to these unprecedented inspection requests, SEC staff for the first time has suggested that investment advisers have an obligation to review or monitor e-mail of employees.

These inspection requests and the staff's comments regarding e-mail surveillance represent a significant departure from past practices. The new inspection practices have caused many investment advisers to incur substantial costs to comply with requests.[2]

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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 more than 350 federally registered advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. Additional information about the ICAA is available on our web site: www.icaa.org.

[2] For example, one of our larger firms reports that it has spent nearly $350,000 since last fall to capture and search e-mail. This figure includes the cost of hardware, software, and some labor costs associated with reviewing the results of searches. This firm receives approximately 20,000 messages per day in approximately 1,000 different mailboxes. The average message is approximately 25 kilobytes in size.

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SEC staff comments regarding monitoring of e-mail have caused advisers considerable uncertainty as to what is required of them with respect to e-mail retention and surveillance.

In light of several enforcement cases that have been brought during the past year, we understand SEC staff's desire to inspect investment adviser e-mail. However, investment advisers have a compelling and legitimate need to be notified and to understand what the rules are *before* the SEC proceeds to engage in new practices that are based on newly articulated expectations. Many investment advisers are contemplating major decisions regarding technologies and firm practices regarding electronic communications – decisions that have significant cost and operations implications – but they are doing so without any written guidance from the Commission regarding legal expectations in this area. We believe it is unfair to ask investment advisory firms to make major decisions resulting in substantial investments in time and money based on anecdotal reports of SEC staff inspection requests and comments. Instead of allowing new regulatory policies to be set by inspection activities, the Commission should issue a proposed rule on this subject and give interested parties an opportunity to comment.

We believe the vast majority of investment advisers have a genuine desire to be cooperative and compliant regarding these and other compliance issues, but they need to know *on a prospective basis* what their legal obligations are. It is a matter of fundamental fairness that advisers not be penalized on a retroactive basis for failing to take actions that the Commission did not previously require and has yet to formally adopt.

Retention and Production of E-Mail Communications

Rule 204-2 of the Investment Advisers Act specifies the records and information investment advisers are required to maintain ("required information"). The SEC construes the general authority of section 204 of the Advisers Act to entitle it to review *any* record or information maintained by an investment adviser, including records or information that do not fall under rule 204-2 (unless privileged). As noted above, OCIE now routinely includes requests for e-mail as a standard aspect of its document requests. These requests have included requests for all e-mail of the firm or for particular individuals (generally high-level management) for a certain period of time (*e.g.*, three months) in an electronically searchable format.[3]

A number of issues have been raised in the past year in light of these requests. First, some advisers do not have all of the e-mails that are requested because they have not saved e-mails that do not include required information under Rule 204-2. The staff has acknowledged that firms are not required to retain e-mail that does not include required information; they have cautioned, however, that firms must have policies and

[3] Further, in at least one recent mini-sweep, OCIE staff has provided each adviser a list of search terms that the firm must use to find e-mail relating to market-timing and requested that the firm provide a summary of the number of hits per search term used in the e-mail search process.

procedures reasonably designed to ensure that required information is maintained. We request confirmation that this process can be satisfied in a number of different ways and that firms need not employ a gatekeeper system to review all e-mail before deletion. For example, robust, periodic training of employees on record retention – both paper and electronic – may satisfy an adviser's duty to maintain required books and records.[4] We further submit that an adviser that has taken such reasonable measures to capture and separate its required electronic information is not obligated to save any remaining non-required information.[5]

Second, some advisers, in addition to retaining required records, maintain *all* their e-mail on back-up disks for contingency planning purposes. These disks were never intended to be searchable for the purposes of responding to a document request; therefore these firms have incurred considerable expense obtaining additional storage capacity and hiring specialists to restore the contents and transfer the requested material to a searchable format. Despite current inspection requests (*e.g.,* for all e-mail in electronically searchable format, Concordance database, or PST format), no adopted rule requires these non-required records to be kept in any particular format. Until specifically required by a rule or other formal Commission action, advisers should be permitted to produce records to inspection staff in any format or medium.[6]

Third, some advisers print e-mail that contains required information and delete the electronic version in accordance with a systematic destruction policy. These advisers are concerned about a view expressed by some SEC staff that advisers must maintain the "functionality" of the e-mail document. Many smaller firms print e-mail that includes required information and maintain it in paper format, because they have determined this is the procedure that best accommodates their business practice. No existing rule has been understood to require that e-mail containing required records be maintained electronically rather than on paper.[7]

Finally, as discussed above, the SEC's position that it can review any record of the adviser during an examination does *not* imply that investment advisers are *required* to maintain all records. On occasion, the examination staff has seemed to ignore this

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[4] We believe that employees can be trusted to self-administer procedures. For example, in firms that train their employees to recognize and maintain required records, the employees are responsible for maintaining such records and the firm spot-checks the process to identify any potential problems. This process may, under appropriate circumstances, be achieved by reviewing or spot-checking paper records.

[5] Many firms feel that they in essence must keep all e-mail traffic for five years for fear that the inspection staff will not accept reasonable procedures but instead will demand "proof" or absolute certainty that all required records have been saved. In fact, it is virtually impossible to prove conclusively that no records have ever been discarded or destroyed. We request the staff to provide reassurance that reasonable procedures and processes for record maintenance, if appropriately implemented, are sufficient.

[6] Rule 204-2(g) provides that *required* records maintained electronically must be arranged in a way that permits easy location and access. There is no such requirement for *non-required* records.

[7] Rule 204-2(g) permits but does not require electronic maintenance of documents.

important distinction. For example, the staff wrote in a recent deficiency letter that section 204 states that all records of advisers are subject to inspection and therefore "investment advisers are required to maintain all e-mail of their employees." This is simply an incorrect statement of the law and rules.

Monitoring or Surveillance of E-Mail Communications

OCIE staff has suggested that advisers must monitor or review employee e-mail for violations of the federal securities law as an aspect of advisers' supervisory controls and implementation of their compliance programs under rule 206(4)-7. The compliance program rule, however, does not specifically impose any such requirement. In fact, the adopting release accompanying the rule expressly permits each firm to tailor its compliance program to the nature of the firm's operations.[8]

We believe that the flexibility permitted by the Commission in the compliance program rule should not be eliminated indirectly via the inspection program. Investment advisers may implement policies and procedures that are *reasonably* designed to prevent and detect violations of the Advisers Act without reviewing their employees' e-mail. For example, compliance testing that analyzes information over periods of time to identify unusual patterns, in combination with transactional reviews, may be deemed a reasonable means to detect violations.[9] The term "reasonable" also conveys the notion of whether the costs and burdens involved in the activity are justified by the potential benefit. For example, most advisory firms will be able to sample only a small percentage of e-mail in their servers. The likelihood of detecting violations through e-mail sampling that could not be detected through other means is relatively small and, for many firms, would likely be outweighed by the costs.[10]

Although we strongly believe the SEC should confirm that advisers are not required by the compliance program rule or any other law to monitor or review employee e-mail, we understand that advisers may wish to consider e-mail surveillance, where appropriate, as one potential method in their arsenal to detect violations.

Interpretation of Rule 204-2(a)(7) under the Investment Advisers Act

Under Rule 204-2, investment advisers are required to make and keep a specific list of books and records. The SEC staff has, over the past several years, informally interpreted this rule to require advisers to maintain any electronic records that contain information otherwise required to be kept under the rule. In other words, information that

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[8] While broker-dealers are required to review outgoing and incoming correspondence with the public (including e-mail) under NASD rule 3010, there is no analogous rule for investment advisers.

[9] *See Compliance Programs of Investment Companies and Investment Advisers*, IA Rel. No. 2204 (Dec. 17, 2003) at n. 15.

[10] Even with respect to market-timing, advisers or other fund service providers may have been able to detect such activity through forensic testing of fund transactional data.

would have to be retained if written or printed on paper must be maintained if in electronic medium.

The concept of electronic records has become particularly problematic in the context of the section of the investment adviser recordkeeping rule pertaining to "written communications." Rule 204-2(a)(7) states that advisers must maintain "all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given; (ii) any receipt, disbursement or delivery of funds or securities; or (iii) the placing or execution of any order to purchase or sell any security."[11] SEC staff informally has stated that "written communications" include e-mail communications. Beyond this guidance, the scope of the provision remains somewhat murky.[12]

In 1998, we wrote the Division of Investment Management regarding confusion over whether subsection (a)(7) includes internally created documents regarding recommendations.[13] This ambiguity was never clarified or resolved. Since then, the dramatic increase in internal communications via e-mail has made this ambiguity an even more pressing matter. We understand that some OCIE staff now take the position that subsection (a)(7) includes communications among a firm's employees regarding recommendations and advice. Many practitioners in the investment advisory profession, however, have understood the term "communications sent by such investment adviser" to refer to communications between the investment adviser firm and other parties. We suggest that this section be interpreted consistently with how it has been reasonably construed historically by such practitioners – *i.e.*, it covers communications sent and received by the firm, as opposed to internal communications. The alternative would create a dramatic change in normal and accepted business practices to the detriment of the adviser's ability to conduct business efficiently for its clients.[14]

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[11] By specifying the content of communications required to be kept, this provision is narrower than the broker-dealer requirement under Exchange Act rule 17a-4 to maintain all correspondence related to the firm's "business as such." In addition, rule 17a-4 specifically includes "internal" communications, while rule 204(a)-7 does not.

[12] For example, there have been varying interpretations of whether communications related to advice or recommendations requires retention of all correspondence to and from clients or only those communications that substantively discuss clients' portfolio holdings and transactions.

[13] *See* letter dated July 6, 1998 from Karen L. Barr, ICAA General Counsel to Robert E. Plaze, Associate Director, Division of Investment Management, SEC re: Revisions to the Books and Records Provisions.

[14] It would be helpful if the SEC could also address issues related to hybrid media, such as instant messaging or other devices that could be seen as a combination of telephone communications (not covered by rule 204-2(a)(7)) and e-mail communications (arguably a "written" communication covered by rule 204-2(a)(7)). Any interpretation in this area should include ample time for comment by the investment adviser community so that the issue is fully vetted.

Conclusion

In closing, we strongly urge that any new interpretation or clarification of the existing recordkeeping rules under the Advisers Act be applied prospectively only and not enforced retroactively against advisers. Recognizing that rule 204-2 is seriously outdated, we nevertheless submit that it is a matter of fundamental fairness that the rulemaking process be used to make changes. Additionally, to the extent that recordkeeping requirements are expanded, firms need sufficient time to select and implement appropriate technologies and procedures to satisfy the new requirements. We also recognize that, because the rule is outdated, it is incumbent upon the investment adviser profession to take a proactive approach in formulating appropriate record retention and monitoring practices. We look forward to working with you on this effort.

We would be pleased to discuss further any of these issues with you. I trust you will not hesitate to contact us if we may provide any additional information or assistance in this regard.

Sincerely,

David G. Tittsworth

DAVID G. TITTSWORTH
Executive Director

ICAA

December 16, 2004

Via Electronic Mail

Paul Craig
Wholesale and Prudential Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Mr. Craig:

The Investment Counsel Association of America (ICAA) greatly appreciates the opportunity to comment on the Financial Services Authority's Policy Statement 04/23 (PS 04/23) entitled *Bundled brokerage and soft commission arrangements: Update on issues arising from PS 04/13* (November 2004).

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 $4 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, or provide investment management services to UK clients.[1]

PS 04/23 sets forth the FSA's preliminary views regarding which products and services may be paid for with commissions. This policy statement follows a consultation paper issued last year, CP 176, which would have required investment advisers to rebate to clients the value of goods and services that are softed or bundled.[2] The ICAA expressed serious concerns regarding the proposal to require rebates and commented that a disclosure regime would more appropriately address the FSA's concerns.[3] In May 2004, the FSA published Policy Statement 04/13, in which it recognized that its goals

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1 Founded in 1937, the ICAA today consists of more than 350 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.

2 Consultation Paper 176 (CP 176) entitled Bundled Brokerage and Soft Commission Arrangements (April 2003).

3 Letter to Ashley Kovas, Business Standards Department, FSA, from Karen L. Barr, ICAA General Counsel (October 9, 2003).

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could be achieved by means other than the rebate proposal. The FSA stated that commissions should be used only for purchase of execution and research and promised further clarification of these terms. At that time, the FSA also challenged the UK asset management industry to develop a meaningful disclosure proposal by year-end. We applaud the FSA's considered decision not to proceed with the rebate proposal and to study other options, including industry-led initiatives, for achieving transparency and accountability.

To assist the industry disclosure effort, PS 04/23 builds on PS 04/13 by providing insight into the FSA's views regarding which products or services may fall within "non-permitted services," "execution," and "research." We commend the FSA for addressing these difficult issues and offer the following comments.

Definition of Research. The FSA has proposed to define "research" so as to encompass a value-added component to the investment or trading decision-making process, representing original thought, intellectual rigor, and analysis or manipulation of data. The definition of research would include both bundled and third-party research and would not favor one medium of delivery over another. In general, we believe this to be a reasonable approach to the concept of "research." We particularly commend the FSA for not differentiating between bundled and softed (third-party) services in its definition. This position will assist in encouraging the development of independent research and analysis to the benefit of investors.[4]

The need for further clarity remains, however, in applying the FSA's definition of research in certain areas. For example, we encourage the FSA to provide guidance regarding the treatment of computerized data services and analytics that constitute more than merely raw data feeds. In addition, services that aggregate and present data in various user-friendly formats may well add value to the investment management process.

In addition, we question whether terms such as "intellectual rigor" and "original thought" are too subjective. Will a manager's traders and portfolio managers be required to analyze the rigor of content on an item-by-item basis? We would suggest a more objective focus on intellectual content, without requiring a case-by-case assessment of whether a particular piece provided is new or has intellectual rigor. For example, the NASD Mutual Fund Task Force recently recommended to the U.S. Securities and Exchange Commission that the definition of "research services" be limited to the "intellectual content" of research.[5] "Intellectual content" would be defined as "any

[4] *See* Statement of Geoffrey I. Edelstein, CFA, CIC, on behalf of the ICAA , before the U.S. Senate Committee on Banking, Housing and Urban Affairs (March 31, 2004) (available on the ICAA's web site, www.icaa.org, under "Comments and Statements").

[5] Report of the Mutual Fund Task Force: Soft Dollars and Portfolio Transaction Costs (November 11, 2004). The Task Force is comprised of senior industry executives who represent broker-dealers and mutual management companies, as well as representatives from the academic and legal community. The Task Force was formed after discussions with the U.S. SEC and NASD staffs to provide guidance to the SEC in this area. The complete text is available at: (http://www.nasd.com/stellent/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf).

investment formula, idea, analysis or strategy that is communicated in writing, orally, or electronically and that has been developed, authored, provided or applied by the broker-dealer or third-party research provider (other than magazines, periodicals, or other publications in general circulation)." This type of terminology may accommodate a more objective decision-making process by investment managers regarding whether a product is "research," while preserving the FSA's concept of adding value.

Definition of Execution. The FSA views "execution" as services provided by a broker that meet two conditions: (1) they are demonstrably linked to the arranging and conclusion of a specific transaction or series of related transactions; and (2) they arise between the point at which the fund manager makes an investment decision and the point at which the transaction is concluded. The FSA would exclude both post-trade execution analytics and custody from the definition of "execution." We have a number of concerns regarding this definition.

First, we believe that the phrase "demonstrably linked" is unworkable in practice and imposes an unnecessary burden on managers. We submit that managers should not be required to demonstrate a link on a trade-by-trade basis, but rather determine the types of services that generally fall within the definition's purview. This concept is supported by the FSA's discussion in PS 04/23 of how elements of a broker's service can be categorized on a general basis.[6] Accordingly, the phrase "demonstrably linked" should be eliminated in favor of a "related to" or similar standard.

Second, analysis of experiences with prior trades may play an important role in a manager's best execution decisions for current transactions. As such, post-trade analytics are inherently part of the execution decision for any particular trade and should be within the definition of "execution." Further, post-trade analytics clearly add value to the investment and trading decision-making process and therefore should be deemed to be "research."

Finally, the FSA appropriately recognizes that certain brokerage activity is "not a 'service' in its own right."[7] Brokers may engage in activity or provide certain products at no charge in order to make transactions easier to handle. For example, in the U.S., many brokers do not charge for custodial services or for dedicated phones lines that are part of the communication system between the adviser and the broker. The broker provides these services presumably to make trading easier for *the broker*. It is easier for the broker to have the adviser connected via dedicated phone line to its system and to settle trades into accounts over which it has custody. We respectfully submit that such activities or products are not "paid for" or "purchased" by the manager with commissions and therefore should rest outside the realm of potential rulemaking in this area.

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6 *See* PS 04/23 at 9-10.

7 PS 04/23 at 9 (paragraph 2.15).

Disclosure Regime. We are pleased that the FSA has recognized the drawbacks associated with its rebate proposal and has instead embraced a disclosure regime to achieve the same goals. Enhanced disclosure will provide transparency and accountability to the process, permitting clients and their managers to better negotiate how costs and fees are arranged and borne. We remain concerned, however, with how advisers, for purposes of disclosure, will be able to value the component services they receive from broker-dealers as part of a single package for an agreed commission.[8] We understand that an industry working group is developing a proposal addressing attribution of commission between research and execution based on forward-looking assumptions agreed to by brokers and managers. We trust that the FSA will allow sufficient time for development and testing of this proposal before expecting disclosure of such attributed values by managers.

Territorial Scope. The FSA takes the position that its conduct of business rules "apply to UK authorised firms carrying on designated investment business in the UK, regardless of the location of the client."[9] The FSA recognizes, however, that "practical problems could arise where, for example, mandates are delegated to a UK firm from an overseas affiliate that may be subject in its own jurisdiction to particular regulatory requirements and client reporting conventions."[10] In light of these and related practical problems, we very much appreciate the FSA's intention to accord careful consideration to territorial issues as it develops rules in this area.[11]

In contrast to the FSA conduct of business rules, PS 04/23 indicates that the industry's forthcoming disclosure regime would be expected to apply to UK clients' mandates. We generally support this approach regarding application of disclosure protocols. We request further consideration, however, regarding situations where a UK authorised firm validly delegates a UK client mandate to a non-UK investment manager. Under these circumstances, we submit that it would be burdensome for the non-UK firm to comply with an extraterritorial disclosure framework. The UK authorised firm delegating the mandate would remain responsible for ensuring that delegation is appropriate and does not disadvantage its clients.

Finally, we are pleased that the FSA has engaged in a dialogue with the U.S. SEC to coordinate efforts regarding soft dollar rules and regulations affecting international asset managers. Because of the global implications of the FSA's actions and increasing globalization of the asset management industry, coordination with other regulatory entities, including the U.S. SEC and European regulators, is critical to facilitating compliance with and clarification of these rules.

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8 *See supra* n.3 at 3-4.

9 PS 04/23 at 15 (paragraph 2.43).

10 PS 04/23 at 15 (paragraph 2.43).

11 *See* PS 04/23 at 16 (paragraph 2.44).

* * * *

We truly appreciate your consideration of our comments on PS 04/23. Please do not hesitate to contact us if we may provide additional information or assistance to you regarding these issues.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

ICAA

December 30, 2004

Via E-mail

CFA Institute
CFA Centre for Financial Market Integrity
Reference: Guidance Statement on Wrap Fee/SMA Performance
P.O. Box 3668
Charlottesville, VA 22903

Re: Proposed GIPS Guidance Statement on Wrap Fee/Separately Managed Account Performance

Ladies and Gentlemen:

The Investment Counsel Association of America[1] appreciates the opportunity to comment on the CFA Institute's (Institute) and Investment Performance Council's proposed Guidance Statement on Wrap Fee/Separately Managed Account Performance (the Statement).[2] We commend the Institute for re-proposing and attempting to clarify the Institute's wrap fee/SMA performance guidance for the GIPS standards[3] and for giving interested parties an opportunity to comment on these important issues. We remain concerned, however, that many of the key issues we raised in our comment letter in 2002 have not been addressed.[4] We incorporate that letter by reference and focus here only on two critical issues – the recordkeeping requirements and the proposed compliance date. We respectfully submit that advisers will not be able to comply with the recordkeeping requirements and certainly not by the compliance date.

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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 more than 350 federally registered advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. Additional information about the ICAA is available on our web site: www.icaa.org.

[2] The Statement is available at http://www.cfainstitute.org/standards/pdf/SMA_Wrap_Fees.pdf. The Statement would apply to investment management firms that claim AIMR-PPS or GIPS compliance and are discretionary portfolio managers of wrap fee/SMA portfolios.

[3] The Statement follows a previous Guidance Statement on Wrap Fee Performance proposed by the Institute (formerly AIMR) in June 2002 for the AIMR-PPS standards (2002 Statement), available at http://www.cfainstitute.org/standards/pdf/wrapfee.pdf.

[4] See *ICAA Comment Letter to AIMR Re: Proposed Guidance Statement on Wrap Fee Performance* (Oct. 31, 2002) (2002 letter), available at http://www.icaa.org/public/letters/compendiums/letterscompendium-2002.pdf.

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Underlying Records

We appreciate the Institute's acknowledgement that many investment management firms may not be able to gain access to the records necessary to substantiate performance on a retroactive basis (for periods before January 1, 2006, the effective date of the Statement). We are also pleased the Institute has not required managers that did not maintain the records to wait until they are able to build a five-year compliant track record with supporting records in order to claim compliance with the GIPS standards. However, we remain concerned about the three "options" the Institute has identified to satisfy the proposed GIPS standard for underlying records for wrap fee/SMA portfolios.

GIPS Standard 1.A.1 requires that: "All data and information necessary to support a firm's performance presentation and to perform the required calculations must be captured and maintained." The Statement interprets this to mean managers must maintain or have access to supporting records for all portfolios included in a composite. The Statement notes that many managers do not maintain or have access to the data necessary to substantiate performance. As a solution, the Statement provides three options to satisfy this requirement. First, managers could place reliance on the performance calculated and reported by the sponsor, provided the manager takes the necessary steps to satisfy itself that the information provided by the sponsor meets the requirements of the AIMR-PPS or GIPS standards and, as necessary, obtains an agreement with the sponsor to secure access to the underlying records. Second, managers could use a "shadow accounting" system to track the SMA portfolios on their in-house performance measurement systems. Third, managers could exclude the SMA division from the definition of firm.[5] For reasons we discussed in our 2002 letter, we believe that it is unrealistic to use any of the recommended options because they are extremely difficult, if not impossible, to implement.[6] Further, some managers may be forced to stop managing wrap fee/SMA programs rather than maintain the proposed AIMR-PPS or GIPS recordkeeping requirements for these programs.

We believe the first option of relying on the performance calculated and reported by the sponsors is unreasonable because sponsors generally do not provide managers with access to individual account information that may be necessary for the manager to satisfy itself regarding the sponsors' performance calculations. The Statement notes that all managers "must exhaust all methods to gain, recreate, or obtain access to the performance records to substantiate portfolio returns. Cost must not be considered an excuse for the ability of a firm to obtain records." These assertions reflect a misunderstanding of the nature of the relationship between the sponsor and the manager. Cost alone is not the prohibitive factor. Sponsors guard this information as a valuable asset, and managers do not have the leverage to negotiate access. Moreover, sponsors generally continue to be unwilling or unable to provide regular electronic data feeds with trade and other information that are necessary to make accurate performance calculations. Further, many sponsors do not follow GIPS standards, and managers do not have sufficient power in these relationships to require sponsors to do so.

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[5] Under the GIPS standards, a firm may define itself as an investment firm, subsidiary, or division held out to clients or potential clients as a distinct business unit (*e.g.*, a subsidiary firm or distinct business unit managing private client assets may claim GIPS compliance for itself without its parent organization being in compliance).

[6] *Supra* n.4.

As a result, it is unreasonable to place the burden on the manager of assessing whether the sponsor's performance calculations are compliant with the GIPS standards, particularly without access to adequate information.

We believe the second option, shadow accounting, is beyond what is technologically feasible at present. As we mentioned in our previous comment letter, shadow accounting makes little sense economically and practically because it will be prohibitively expensive and time-consuming to manually reconcile the literally thousands of accounts within the numerous wrap fee/SMA programs in which a manager may participate. Managers will be forced to face very expensive upgrading systems in order to interface with sponsors' information and trading systems, which are often incompatible with the managers' systems. Manual back-office reconciliations are simply not an option for managers with large volumes of trades in SMAs without significantly increasing resources, employees, and expenses. Further, many sponsors are reluctant to open their proprietary systems to managers. In addition, managers that implement a shadow accounting system may not even have access to sufficient data from sponsors required to comply with the standards. A manager's good faith attempt to obtain the required data to perform shadow accounting has been, and will continue to be, frustrated by the state of the systems in the wrap fee industry and the lack of connectivity among wrap fee sponsors and managers.

Finally, the third option, redefining the firm to exclude the SMA division from the definition of the firm, will not work for firms wanting to implement new wrap products. Although this option is potentially workable for managers that already have well-established wrap fee/SMA products, implementation will be burdensome and time-consuming. A manager that chooses to redefine the firm to exclude the SMA division will incur considerable expenses in employee time and firm resources to recalculate the firm's assets under management, restructure the firm's composites, and rebrand the firm and the SMA division. In addition, managers would not be permitted to show performance from the SMA division except as supplemental information. Further, the non-SMA firm performance may not be shown to prospective SMA clients of the SMA division except as supplemental information. These restrictions present significant drawbacks to redefining the firms to exclude the SMA division.

Compliance Period

We are concerned that the Statement proposes an impractical and burdensome implementation period for managers to comply with the requirements. In light of the proposed adoption date of June 2005, managers will have approximately six months to implement the Statement's requirements. A manager that chooses to rely on the sponsor or to implement shadow accounting systems must have adequate time to amend any contractual agreements with sponsors to reflect these new requirements in the Statement and conduct additional due diligence on the sponsors. Furthermore, a manager that chooses to implement a shadow accounting system will require sufficient time to develop technological interfaces with SMA sponsors in order to automate trade communications and back-office reconciliations. As mentioned above, a manager that chooses to redefine the firm to exclude the SMA division must recalculate the firm's assets under management, restructure the firm's composites, rebrand the firm and the SMA division, and implement new marketing efforts – all of which will require considerable time and firm resources to implement.

Equally troublesome is the proposed requirement that if a manager cannot meet the January 1, 2006 compliance date, it must wait until it has a minimum five-year track record that complies with GIPS before claiming compliance. We believe this requirement unfairly and unjustly penalizes managers that seek to implement a shadow accounting system, given the complexities of having to develop the systems to interface with every SMA sponsor for which the firms manage wrap fee/SMA programs. Managers require more than the proposed implementation period of six months to adjust their operational and technical systems to meet the underlying record requirements. Managers should not be penalized an additional number of years for working toward a solution of GIPS compliance. Accordingly, for all the reasons discussed above, we request that the compliance period be extended for at least two years from the date of the Statement's adoption.

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We appreciate the opportunity to comment on the Institute's Guidance Statement on Wrap Fee/Separately Managed Account Performance, and we would be pleased to work with you further on these issues. Please do not hesitate to contact the undersigned or Karen L. Barr, ICAA General Counsel, if we may provide additional information or clarification with respect to our comments.

Sincerely,

Monique S. Botkin

Monique S. Botkin
Counsel