2007 Comments & Statements

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March 9, 2007

Via Electronic Filing

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles (Release No. 33-8766; IA-2576; File No. S7-25-06)

Dear Ms. Morris:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Commission's proposed anti-fraud rules applicable to advisers to certain pooled investment vehicles, including hedge funds, and proposed rules to increase the financial eligibility requirements for accredited investors in certain private investment vehicles.[2] The latter proposal would establish a new category of accredited investors called "accredited natural persons," which would require ownership of at least $2.5 million in "investments" in order to invest in certain Section 3(c)(1) funds.[3]

The IAA commends the Commission and its staff for addressing these important investor protection issues and supports the Commission's efforts to implement rules to protect investors in certain pooled vehicles from fraudulent conduct.[4] We agree that it is

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, SEC Release No. 33-8766; IA-2576; File No. S7-25-06 (Dec. 27, 2006) (Proposing Release or Proposal), available at http://www.sec.gov/rules/proposed/2006/33-8766.pdf, as published in 72 Fed. Reg. 400 (Jan. 4, 2007).

[3] Section 3(c)(1) funds are offered privately to 100 or fewer beneficial owners. We refer in our letter to Section 3(c)(1) funds generally. However, the Commission has proposed an exclusion from the new standard for investors in "venture capital funds," as defined in the Proposal. *See* Proposing Release at 30-33.

[4] Indeed, we supported the Commission's previous rulemaking to require investment advisers to hedge funds to register under the Investment Advisers Act of 1940, which would have provided important

critical for the Commission to retain its ability to bring enforcement actions against advisers that defraud hedge fund investors. We also support the Commission's efforts to modernize the 25-year old accredited investor standards under the Securities Act of 1933 to ensure that investors in certain private offerings are financially sophisticated enough to understand and bear the economic risk of those investments. A number of modifications are necessary, however, to ensure the proposals appropriately achieve the Commission's goals.

With respect to the proposed "accredited natural person" standard, we respectfully request that the Commission:

- Adopt a fiduciary representative exception to the accredited natural person standard for investors who hire an SEC-registered investment adviser;[5]
- Modify several provisions of the proposed accredited natural person standard, including: (a) conform the proposed accredited natural person standard to that of existing requirements for "qualified clients" under Rule 205-3 of the Advisers Act, or otherwise adjust the current accredited investor standard; (b) conform the definition of "investments" to the definition applicable to investor eligibility for Section 3(c)(7) funds;[6] and (c) eliminate the automatic indexing requirement of the proposed new standard;
- "Grandfather" future capital commitments of current investors in existing Section 3(c)(1) funds affected by the proposed rules;
- Add "knowledgeable employees" of Section 3(c)(1) funds and their advisers to the definition of accredited natural person; and
- Allow sufficient time for compliance with the proposed accredited natural person rules.

With respect to the proposed anti-fraud rule, we respectfully request that the Commission clarify that the proposed rule does not create any new liability under the Advisers Act for an investment adviser to an investment company.

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investor protections. *See* Letter from David G. Tittsworth, Executive Director and Caroline Schaefer, Associate General Counsel to Jonathan G. Katz, U.S. Securities and Exchange Commission (Sept. 14, 2004); *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, SEC Release No. IA-2266, File No. S7-30-04 (Dec. 4, 2004) ("Hedge Fund Adviser Registration Rule")).

[5] The Commission may wish to consider whether other fiduciary exceptions are appropriate.

[6] Section 3(c)(7) funds are offered privately to "qualified purchasers," as defined under the Investment Company Act.

A. Proposed Accredited Natural Person Standard for 3(c)(1) Funds

The Commission has proposed that investors in Section 3(c)(1) funds must: (1) meet the current accredited investor standards of having: (a) a net worth, or joint net worth with the person's spouse, exceeding $1 million at the time of purchase; or (b) individual income exceeding $200,000 (or joint income with the person's spouse of $300,000) in each of the most recent two years and an expectation of reaching the same income level in the year of investment;[7] ***and*** (2) own, individually, or jointly with that person's spouse, not less than $2.5 million (as adjusted for inflation) in "investments."[8] While we support the Commission's reassessment of the financial eligibility standards, we propose an important exception and several modifications as discussed below.

1. Accredited Investors Who Hire a Registered Investment Adviser Should be Excepted from the Proposed Accredited Natural Person Standard

The Commission's proposed accredited natural person standard is designed to provide assurance that an investor has a "level of knowledge and financial sophistication and the ability to bear the economic risk" of an investment in a Section 3(c)(1) fund, as demonstrated by the investor's investment experience and net worth or income.[9] We are concerned, however, that the rules as proposed will prevent investments in these funds by a large class of investors who are financially sophisticated enough to hire an investment adviser registered with the Commission to manage their assets on a discretionary basis.[10] We believe that the retention of a registered investment adviser is an appropriate proxy for an investor's own investment experience and satisfies the Commission's goals. In fact, the Commission appears to be seeking the type of investment experience possessed by advisers by adding an investment-based eligibility standard for natural persons in Section 3(c)(1) funds.[11] Accordingly, we propose that the Commission except from the accredited natural person standard investors whose Section 3(c)(1) fund investments are made by the SEC-registered investment advisers they retain, as fiduciaries, to manage their assets on a discretionary basis.[12]

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[7] *See* Securities Act Rules 215(e),(f) and Rules 501(a)(5),(a)(6).

[8] Proposed Securities Act Rules 215(e),(f), 216, 501(a)(5), (a)(6), 509.

[9] Proposing Release at 18-19.

[10] The Commission has long treated accredited investors meeting the requirements under the Securities Act as sufficiently sophisticated to be able to make their own investment decisions. Certainly, such accredited investors are sophisticated enough to choose an investment adviser to make investment decisions for them.

[11] Thus, we propose this exception for the Commission's proposal to adopt an accredited natural person standard and not with respect to the current requirements for accredited investors under Regulation D.

[12] Advisers managing assets on a discretionary basis have the authority to make investment decisions on behalf of their clients. Such advisers may discuss potential private fund investments with their clients before making the investment, and clients will sign the subscription agreement and other documents as

The Commission's concern about these investors should be alleviated by the fact that SEC-registered investment advisers are obligated to place their clients' interests above their own. An investment adviser stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients.[13] As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients. The parameters of an investment adviser's duty depend on the scope of the advisory relationship and generally include: the duty at all times to place the interests of clients first; the duty to have a reasonable basis for its investment advice; the duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines, and restrictions; the duty to treat clients fairly; and the duty to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest.[14] These obligations of SEC-registered investment advisers provide substantial protections for their clients, including those invested in Section 3(c)(1) funds.[15]

Specifically, in the course of their duties, investment advisers conduct research and due diligence on certain hedge funds, private equity funds, and venture capital funds, among others, on behalf of their investors before making an investment in such fund for their clients. The recommendations or investments are vetted by advisers after satisfying their duties to make investment decisions in the best interest of their clients. In addition, advisers are required to understand the complexities and risks of any investment vehicle in which they invest their clients' assets. This unique relationship should satisfy the Commission that these investors are appropriately protected and able to accept the risk of those investments.

A similar concept, one of a "purchaser representative," is found in Regulation D under the Securities Act.[16] A purchaser representative is required to have such

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appropriate. In so doing, clients may acknowledge that the adviser is their representative during the course of the purchase of a fund investment. *See, e.g.,* Securities Act Rule 501(h)(3) (requirements for purchaser representative).

[13] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 201 (1963).

[14] *Id.; see also In re Arleen Hughes*, SEC Release No. 34-4048 (Feb. 18, 1948); IAA Standards of Practice, as amended February 28, 2006, available at: http://www.icaa.org/html/sop.html.

[15] In addition, SEC-registered advisers are subject to Commission inspections and examinations under the Advisers Act. They are also obligated to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act, review those policies and procedures annually, and designate a chief compliance officer to be responsible for administering the policies and procedures. *See* Rule 206(4)-7; *Compliance Programs of Investment Companies and Investment Advisers*, SEC Release Nos. IA-2204; IC-26299; File No. S7-03-03 (Dec. 17, 2003).

[16] Securities Act Rule 501(h). The Commission has stated that purchaser representatives may in fact be investment advisers. *See Interpretive Release on Regulation D,* SEC Release No. 33-6455, 1983 WL

knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment.[17] Likewise, a registered investment adviser has knowledge and experience in financial and business matters and is capable of evaluating, and does evaluate, the merits and risks of prospective investments in Section 3(c)(1) funds for its clients.[18]

Indeed, the Commission acknowledges in the Proposing Release that a similar category of natural person investors does not need the protection of a higher accredited investor standard:

> [N]atural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. *This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles.*[19] (emphasis added.)

We respectfully submit that a natural person's retention of a registered investment adviser provides the same level of protection as the pooled vehicle's retention of a plan fiduciary or "registered investment professional" cited with approval by the Commission.[20] Many natural persons have in fact retained registered investment advisers to make investments on their behalf, including in Section 3(c)(1) funds. Accordingly, the Commission should acknowledge this protection and adopt an exemption to the accredited natural person standard for natural person investors who hire an investment adviser registered with the Commission to manage their accounts on a discretionary basis.

409415 (Mar. 3, 1983) at 7, n. 24 (citing SEC no-action letters *Winstead, McGuire, Sechrest & Trimble* (pub. avail. Feb. 21 and Mar. 25, 1975) and *re Kenisa Oil Company* (pub. avail. May 6, 1982)).

[17] Securities Act Rule 501(h)(2).

[18] In addition, a purchaser representative is obligated to disclose to the purchaser in writing any material relationship between himself or his affiliates and the issuer or its affiliates that then exists or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship. Securities Act Rule 501(h)(4). Similarly, a registered investment adviser is required to make disclosures regarding material conflicts of interest it has in relation to its position for the accredited investor.

[19] Proposing Release at 18.

[20] *See also* President's Working Group on Financial Markets, *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, at section 5 (Feb. 22, 2007), which noted that fiduciaries that manage pension funds, fund-of-funds, or other similar pooled investment vehicles "have a duty under applicable law to act in the best interest of the beneficiaries. They have an ongoing responsibility to perform due diligence to ensure that their investment decisions are prudent and conform to sound practices for fiduciaries." Advisers, as fiduciaries, provide the same level of protection and similar functions with respect to their clients' investments.

2. The $2.5 Million Investments Threshold Should Be Modified

a. The Standard is Not an Appropriate Proxy for Financial Sophistication

The Commission has proposed that an accredited natural person must have $2.5 million in "investments," excluding personal residences, in order to invest in Section 3(c)(1) funds. We are concerned that this threshold may be higher than is necessary to achieve the Commission's goals and may have negative collateral consequences. One of the keys to reducing portfolio risk is diversification within and across asset classes. Many natural persons today, including clients of registered investment advisers, seek a variety of alternative investments, including hedge funds, private equity funds, and venture capital funds, as vehicles to greater diversify their portfolios. The Commission's approach seems to overlook the fact that certain investors and clients of investment advisers can afford to have – and choose to have – relatively illiquid investments in a segment of their portfolio. Thus, the proposed threshold may negatively affect responsible portfolio diversification. In addition, reducing the pool of available investors so significantly may unduly limit the creation of potential new funds while providing a competitive advantage to larger, existing pooled vehicles over smaller funds. For these reasons, we offer an alternative to the proposed $2.5 million in investments discussed below.

b. The Standard Should be Harmonized with the "Qualified Client" Standard under Advisers Act Rule 205-3

As an alternative to the proposal, we believe the Commission should consider harmonizing the accredited natural person standard with that of the $1.5 million net worth requirement applicable to "qualified clients" of an adviser that charges performance fees under Advisers Act Rule 205-3.[21]

We note that the proposed rules are designed to address a regulatory gap caused by the court's invalidation in *Goldstein v. SEC* of the Commission's rule requiring registration of certain hedge fund advisers.[22] Because virtually all hedge funds charge performance fees, that rule would have, in effect, required hedge fund investors to have $1.5 million in net worth by virtue of compliance with Rule 205-3. Thus, we suggest harmonizing the accredited natural person standard with the qualified client standard of $1.5 million net worth. This approach would also have the benefit of avoiding the

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[21] Advisers Act Rule 205-3(d)(1). Qualified clients include natural persons who immediately after entering into the advisory contract have at least $750,000 under the management of the investment adviser or have a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1.5 million at the time the contract is entered into. *See* Proposing Release at 25, n. 61.

[22] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (vacating and remanding Hedge Fund Adviser Registration Rule).

creation of yet another standard for eligibility in the securities laws – ***i.e.***, adding "accredited natural person" to "accredited investor" under the Securities Act, "qualified client" under Advisers Act Rule 203-5, "qualified purchaser" under Investment Company Act Section 3(c)(7), "qualified institutional buyer" under Securities Act Rule 144A, and "qualified eligible persons" under CFTC Rule 4.7. The application of these differing standards is burdensome and complicated from a compliance standpoint.

Alternatively, if the Commission determines not to adopt the qualified client standard, the Commission should instead increase the thresholds of the current accredited investor standard under Securities Act rules, or increase the current accredited investor standard by excluding investors' personal residences in the net worth calculation.[23] This may be the simplest and easiest method to implement administratively and would achieve the Commission's goals.

c. <u>"Joint Investments" Should Receive the Same Treatment as in Investment Company Act Rule 2a51-1</u>

For purposes of the accredited natural person standard, the Commission proposes to treat investments of a natural person owned jointly with a spouse, or that are part of a shared community interest, differently than the treatment of such investments under Investment Company Act Rule 2a51-1 for Section 3(c)(7) funds. Specifically, the Commission proposes that for purposes of determining whether a natural person, acting on that person's own behalf (and not jointly with a spouse), should be able to qualify as an accredited natural person, the person's investments should include only ***a portion*** of the amount of any investments owned jointly, or of any investments which ownership is shared, with the person's spouse.[24]

In contrast, Rule 2a51-1 for Section 3(c)(7) funds permits all of such investments, rather than a portion, to be included in the determination of whether a natural person is a "qualified purchaser."[25] In determining whether a natural person is a qualified purchaser under Rule 2a51-1, the person may include investments held jointly with the person's spouse or any investments in which the natural person shares with his or her spouse a

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[23] The Commission may coordinate these changes with any other amendments to Regulation D that the Division of Corporation Finance may be considering.

[24] The proposed rules provide that the investments of a natural person seeking to make an investment in a Section 3(c)(1) fund on his or her own behalf may include *only 50 percent* of the following: (a) any of the person's investments held jointly with that person's spouse; and (b) any investments in which the person shares a community property or similar shared ownership interest with that person's spouse. *See* Proposing Release at 28; Proposed Securities Act Rules 216(c)(4), 509(c)(4).

[25] *See* Proposing Release at 27-28.

community property or similar shared ownership interest.[26] In fact, the Commission stated in the release adopting Rule 2a51-1 that it "believes that th[e] approach [adopted] will simplify the determination of whether spouses making a joint investment are qualified purchasers." The Commission provides no rationale for this different treatment of joint investments for the accredited natural person standard.

Further, the proposal would require investors and/or fund sponsors to make determinations about the legal characterizations of the assets of an investor based on the requirements of his or her state of residence, including whether or not an asset is considered community property. This complex requirement would likely lead to inconsistent application, which would not serve to further the Commission's goals. Instead, we believe that the "bright line" test in Rule 2a51-1 should be adopted to assess the ownership of "investments" of an accredited natural person.

d. <u>An Automatic Inflation Adjustment is Inconsistent with Section 3(c)(7)</u>

The Commission has proposed to adopt a rule that would automatically index the $2.5 million for the amount of investments that a person would be required to own under the proposed definition of accredited natural person.[27] We prefer the Commission refrain from requiring automatic indexing for inflation, which may be more complicated and difficult to monitor than an absolute number as currently proposed. In addition, the Commission has not required indexing of the $5 million in investments that natural persons must own to be qualified purchasers eligible to invest in Section 3(c)(7) funds. We believe the Commission should retain the flexibility to reassess the "accredited natural person" criteria periodically and adjust it as necessary for inflation, market conditions, and other relevant factors.

3. <u>Current Section 3(c)(1) Fund Investors Should be "Grandfathered" for Future Investments in the Fund</u>

We understand the proposed rules would permit current accredited investors who would not meet the new accredited natural person standard to retain their existing investments in Section 3(c)(1) funds.[28] We request confirmation of our understanding in the final rules and the adopting release.

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[26] Investment Company Act Rule 2a51-1(g)(2). *See Privately Offered Investment Companies*, SEC Release No. IC-22597, File No. S7-30-96 (Apr. 3, 1997) at 34-35.

[27] *See* Proposing Release at pp. 23-24.

[28] *See* Proposing Release at 25. If our interpretation is incorrect, we strongly believe current investors should be grandfathered from application of the new accredited natural person standard and not required to divest their current holdings. We believe it would be unfair to current investors in Section 3(c)(1) funds and disruptive to the markets generally to require investors who do not meet the proposed accredited natural person standard to be required to dispose of their interests in the funds. In addition, the Commission's former rule requiring hedge fund advisers to register with the Commission would have

In addition, we urge the Commission to permit current investors in Section 3(c)(1) funds to continue to make future investments in these funds. In some instances, this is necessary to facilitate investors' investment or contractual obligations. Additional investments in these funds may be needed or desired to allow for the continuation of a long-standing investment plan or to implement an investor's periodic reallocation and rebalancing of his or her portfolio. In addition, certain closed-end Section 3(c)(1) funds have contractually obligated their investors to make capital commitments over the life of the fund. We also respectfully submit that it is a matter of fundamental fairness to permit future investments in the same fund for individuals who relied on existing and legitimate rules at the time of their initial investment.

4. Knowledgeable Employees Should Be Included in the Definition of Accredited Natural Persons

The rules as proposed may have the effect of precluding an employee of a Section 3(c)(1) fund or the fund's adviser from investing in the fund if he or she does not meet the accredited natural person standard, despite the fact that the employee may meet the definition of a "knowledgeable employee" as defined in Investment Company Act Rule 3c-5.[29] We believe the Commission should add to the list of accredited natural persons "knowledgeable employees" of Section 3(c)(1) funds and their advisers, as that term is defined in Rule 3c-5.[30]

The proposal, if adopted, would result in an unusual outcome whereby a knowledgeable employee may invest in a Section 3(c)(7) fund, which requires an investor to have $5 million in investments, but not invest in a Section 3(c)(1) fund, which would have a proposed threshold of $2.5 million in investments. Moreover, investors, and particularly institutional investors, expect employees of sponsors of Section 3(c)(1) funds to invest alongside the investor with a capital commitment demonstrating the sponsor and employees' dedication to the fund's success. In addition, these funds are often utilized to establish new investment products, and employees at advisers and sponsors are key participants in that process, frequently being the primary sources of seed capital for start-

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amended Advisers Act Rule 205-3 to permit hedge fund advisers to charge performance fees to funds existing at the time of the adoption of the rule that had non-qualified investors, thereby "grandfathering" the current investors in the hedge funds at the time of the rule's adoption. *See* Hedge Fund Adviser Registration Rule, *supra* n. 4.

[29] Under Investment Company Act Rule 3c-5, knowledgeable employees are excluded from the 100-beneficial owner limit for Section 3(c)(1) funds and are excluded from the requirement that only qualified purchasers own Section 3(c)(7) funds.

[30] The Commission may also wish to take this opportunity to consider exempting "knowledgeable employees" from the current accredited investor standards under Regulation D for Section 3(c)(1) and 3(c)(7) funds. Individuals who participate in the investment activities of these private funds would have a substantial understanding of the fund, its structure, and its risks such that the "knowledgeable employee" standard may serve as a substitute for the current accredited investor standard.

up funds. Finally, with the adoption of Investment Company Act Section 3(c)(7), the Congress directed the Commission to draft rules permitting knowledgeable employees to invest in Section 3(c)(1) funds without being counted toward the 100-beneficial owner limit. Clearly, such a concept should apply to these proposed standards. Accordingly, we urge the Commission to add "knowledgeable employees" of a Section 3(c)(1) fund, or adviser of the fund, to the list of accredited natural persons.

5. A Compliance Date of One Year Should Be Adopted

The proposed rules present a significantly different method for assessing eligibility for investors in Section 3(c)(1) funds. If the Commission chooses not to permit grandfathering of current investors so that they may remain invested and make future contributions, Section 3(c)(1) funds and their sponsors will need to determine whether the funds can continue operations without this same large pool of available investors and whether their current investors will be eligible to continue to invest in the funds. In this regard, funds and their sponsors will need to obtain representations about the investments owned by the investor and his or her spouse, including whether the investments are held jointly. Even if current investors are grandfathered, funds will need to revise their subscription documents and processes to incorporate the new accredited natural person standard. Accordingly, in order to comply with the proposed requirements to evaluate investor eligibility, we believe advisers or sponsors to Section 3(c)(1) funds would likely need a one-year compliance date from the effective date of the rule.

B. Proposed Anti-Fraud Rule for Advisers to Pooled Investment Vehicles

Proposed anti-fraud Rule 206(4)-8(a)(1) provides that an adviser to a "pooled investment vehicle" will commit a fraudulent act if it makes any untrue statement of a material fact or omits to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle. Proposed Rule 206(4)-8(a)(2) makes it a fraudulent act to otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. A "pooled investment vehicle" is defined to mean any investment company as defined in Section 3(a) of the Investment Company Act or any Section 3(c)(1) or Section 3(c)(7) fund.

We strongly support the Commission's goal of deterring and punishing conduct that defrauds investors or prospective investors in hedge funds and other similar funds but believe the Commission's objectives are best served by a more targeted approach. We are concerned that the proposed anti-fraud rule is duplicative of enforcement remedies currently available under Section 34(b) of the Investment Company Act for an investment adviser to an investment company. The Commission acknowledges that it believes, "as a general matter, most advisers that advise registered investment companies will, to a large extent, communicate with investors and prospective investors in those funds through documents that are already subject to section 34(b)." The proposed rule is also duplicative of remedies under Advisers Act Sections 206(1) and 206(2) and Securities Act Section 17(a).[31] Duplication is unnecessary and could result in differing or inconsistent interpretations and enforcement practices. Thus, we request that the Commission better target its approach and remove from the definition of "pooled investment vehicle" an investment company defined in Section 3(a) of the Investment Company Act.

Alternatively, we request that the Commission clarify in the adopting release that the proposed rule does not create any new liability for investment advisers to investment companies not already provided for in Advisers Act Sections 206(1) or 206(2) or Investment Company Act Section 34(b).

Conclusion

We commend the Commission for seeking to protect investors in hedge funds. In so doing, the Commission should adopt a fiduciary adviser exemption from the proposed accredited natural person standard and our other recommended enhancements to the proposals.

We appreciate the opportunity to provide our views on these important issues. Please do not hesitate to contact the undersigned if the Commission or its staff has any questions or if we may provide any additional information regarding these matters.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

Monique S. Botkin

Monique S. Botkin
Counsel

cc: Hon. Christopher Cox
Hon. Paul S. Atkins
Hon. Roel C. Campos
Hon. Annette L. Nazareth
Hon. Kathleen L. Casey

Mr. Andrew J. Donohue, Director, Division of Investment Management
Mr. Robert E. Plaze, Associate Director, Division of Investment Management
Mr. Douglas J. Scheidt, Chief Counsel, Division of Investment Management

[31] Indeed, we submit that, notwithstanding the *Goldstein* decision, the Commission has sufficient enforcement authority with respect to misconduct by investment advisers registered under the Advisers Act.

INVESTMENT ADVISER
ASSOCIATION

March 15, 2007

By Facsimile and U.S. Mail

Mr. Timothy Le Bas
Deputy Commissioner and General Counsel
Office of Law and Legislation
State of California – Business, Transportation and Housing Agency
Department of Corporations
1515 K Street, Suite 200
Sacramento, CA 95814-4052

Re: Compliance Survey Regarding The California Financial Information Privacy Act

Dear Mr. Le Bas:

Thank you for taking the time to speak with me last week about the survey entitled "Compliance Survey Regarding the California Financial Information Privacy Act" that some members of the Investment Adviser Association[1] recently received from the California Department of Corporations.[2]

According to the survey, the Department is gathering information through its examination process to determine compliance with the California Financial Information Privacy Act (the "Privacy Act") pursuant to its authority under Financial Code Sections 4057 and 4058. In the transmittal letter accompanying the survey, the Department asks that copies of the completed compliance survey be retained, along with any accompanying documents identified in the survey, as books and records "so that Department examiners can request and review these documents during the next [company] examination . . . , as necessary." The survey itself also purports to require advisers that share information in a manner requiring client "opt-in" to maintain records regarding customer complaints, policies and procedures, employee education, and similar matters.

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.
[2] Copies of the survey and transmittal letter are attached hereto.

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The Privacy Act, however, does not impose any record retention requirements on financial institutions, nor does it provide the Department with survey or inspection authority over investment adviser firms. Further, the California Corporate Securities Law does not - and cannot under NSMIA - confer to the Department routine inspection authority over SEC-registered investment advisers nor can it impose record retention requirements over such advisers. Accordingly, while we understand the reasons the Department wishes to obtain compliance surveys from SEC-registered advisers, the statutory provisions cited do not appear to authorize the Department to mandate a response or require record retention.

During our phone conversation, you indicated that a response from our members that received the survey was required, even though those members are SEC-registered investment advisers that are not registered or licensed with the California Department of Corporations. We respectfully request that you clarify that any response to the survey by such investment advisers is voluntary, not mandatory. We also request affirmation that the record retention portions of the survey do not apply to SEC-registered investment advisers. The transmittal sheet accompanying the survey asks for they survey to be returned “within 20 days of receipt.” Accordingly, your prompt clarification of this matter would be greatly appreciated.

Please do not hesitate to contact me if you have any questions or if I may provide any additional information about this matter.

Sincerely,

Valerie Baruch

Valerie Baruch
Assistant General Counsel

April 12, 2007

Office of Exemption Determinations
Employee Benefits Security Administration
Room N-5700
U.S. Department of Labor
Washington, DC 20210
Attention: Cross-Trading Policies and Procedures Interim Final Rule
Response submitted electronically by e-mail (e-OED@dol.gov)

Re: Interim Final Rule Regarding Policies and Procedures Governing Cross-Trading of Securities for ERISA Accounts

Ladies and Gentlemen:

The Investment Adviser Association[1] welcomes the opportunity to comment on the interim final rule issued by the Department of Labor regarding written policies and procedures governing cross trading of securities for ERISA accounts.

Cross-trading by actively managed pension plans is a very important issue for IAA members. The IAA has submitted letters and participated in a number of meetings regarding cross trades with the Department over the years. In May 1998, the IAA submitted a detailed letter to the Department in response to the Department's request for comments on cross-trades in March of that year. Most recently, on September 20, 2006, the IAA submitted testimony in support of the expansion of the cross-trading exemption to the members of the ERISA Advisory Council in the form of a joint panel with the Investment Company Institute.[2]

We commend the Department and its staff for recognizing the important benefits of cross trading for ERISA-covered investors and we appreciate the opportunity to express our views on the interim final rule. Specifically, we urge the Department to revise the interim final rule so that (1) the regulations solely address the content of policies and procedures and are consistent with the provisions of Rule 17a-7 of the Investment Company Act of 1940 ("1940 Act'); (2) the role of compliance officers in the

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] The joint panel presented testimony to the Working Group on Plan Asset Rules, Exemptions, and Cross Trading of the ERISA Advisory Council on Employee Welfare and Pension Benefit Plans (the "EAC Working Group") and the IAA provided a written submission to the EAC Working Group.

interim final rule is consistent with the role of compliance officers set forth in the Investment Advisers Act of 1940 (the "Advisers Act"); and, (3) the minimum asset size requirements of the Pension Protection Act of 2006 ("PPA") are monitored on an annual, not quarterly, basis. We also urge the Department to implement the cross-trading recommendations of the EAC Working Group.

I. The Interim Final Rule Should be Revised so That the Regulations Solely Address the Content of Policies and Procedures, and are Consistent With the Provisions of Rule 17a-7 of the 1940 Act

In August 2006, Congress passed the PPA, which added an exemption to ERISA to allow investment advisers to engage in active cross trades for their ERISA clients with plan assets in excess of $100 million, subject to certain conditions. Among other requirements, the trade must be executed at the current market price of the security and no brokerage commission or fee can be paid to the investment adviser in connection with the trade. In addition, the adviser must execute the cross trade pursuant to written policies and procedures, must seek and obtain client consent, and must provide quarterly reports with detailed information with respect to each cross trade executed by the adviser on behalf of the plan. Finally, the adviser must provide an annual written compliance report to each client. These requirements are similar to the provisions of Rule 17a-7 of the 1940 Act applicable to cross trading by investment advisers to mutual funds.

The PPA also included a provision requiring the Secretary of Labor to issue regulations regarding the content of cross-trading policies and procedures required to be adopted by an investment adviser. Specifically, the PPA provided, "No later than 180 days after the date of enactment of this Act, the Secretary of Labor, after consultation with the Securities and Exchange Commission, shall issue regulations regarding the content of policies and procedures required to be adopted by an investment manager under section 408(b)(19) of [ERISA]." Those regulations, which were issued on February 12, 2007, in the form of an interim final rule, are intended to mandate the style, format, and content of an investment adviser's cross-trading policies and procedures under ERISA.

The IAA supports the Department's requirements that an investment adviser's cross-trading policies and procedures be "clear and concise," "sufficiently detailed," and "reasonably designed to ensure compliance" with the Act, as provided by the interim final rule. These standards clearly address the PPA's mandate to the Department to issue "regulations regarding the content of policies and procedures required to be adopted by an investment manager." We are concerned, however, that certain other requirements imposed by the interim final rule are disclosure obligations rather than "regulations regarding the content of cross-trading policies and procedures." For example, subsection F of the interim final rule requires the identification of "the compliance officer responsible for periodically reviewing the investment manager's compliance with section 408(b)(19)(h) of the Act," and "a statement of the compliance officer's qualifications for the position." These types of requirements simply add disclosure obligations without specifically addressing the content of policies and procedures or providing meaningful protection to ERISA plans. In addition, these types of requirements are inconsistent with the ability of compliance officers to delegate certain tasks, as discussed below.

We are also concerned that, for cross-trading purposes, the interim final rule imposes obligations on investment advisers to ERISA plans that are more extensive and burdensome than the disclosure obligations imposed on investment advisers to mutual funds. Since the adoption of Rule 17a-7 over forty years ago, the policies and procedures set forth in the rule have been overwhelmingly successful in helping to prevent cross-trading abuses by investment advisers. The rule has served as an effective means of ensuring that cross trades are made in the best interests of the clients involved in the transaction.

Many of the provisions of the PPA are substantially similar to the provisions of Rule 17a-7. The parallels between the PPA and Rule 17a-7 are logical. The Department and the SEC share the same underlying policy considerations regarding cross-trade transactions. Both seek to ensure that a fiduciary fulfills its duties to clients by promoting cost savings and market efficiencies for clients while fully protecting the interests of such clients.

In the interim final rule, however, the Department went beyond Rule 17a-7's flexible formulation of requiring procedures "which are reasonably designed to provide that all of the conditions of [the rule] have been complied with," and added a series of what are in essence disclosure obligations solely applicable to investment advisers that engage in cross trades for ERISA accounts. For example, the interim final rule requires that an investment adviser's policies and procedures include "a description of how the investment manager will mitigate any potentially conflicting division of loyalties and responsibilities to the parties involved in any cross trade transaction." This description in the procedures is not needed given that all of the conditions imposed by Congress in the PPA already are intended to mitigate potential conflicts of interest. To the extent investment advisers serve as advisers to mutual funds and pension plans, the different requirements will make application of the rules and the adoption of policies and procedures unnecessarily burdensome. As a practical matter, it will be difficult for investment advisers to maintain cross-trade programs if different procedures apply to different types of clients.

The interim final rule should be consistent with and comparable to the Rule 17a-7 cross-trading provisions and any inconsistencies and additional disclosure obligations should be eliminated from the interim final rule to the extent possible. In addition, the Department should clarify the interim final rule to confirm that the cross-trading exemption set forth in the PPA permits cross-trading between investment advisers and their affiliates, just as Rule 17a-7 permits cross trading between investment companies and their affiliates.[3]

II. The Interim Final Rule Should be Clarified or Revised so That the Department Does not Expand the Scope of a Compliance Officer's Responsibilities

Under the Advisers Act, compliance officers are responsible for reviewing the efficacy of policies and procedures required to be implemented by the Act. Specifically, pursuant to Rule 206(4)-7, a compliance officer is responsible for administering the policies and procedures adopted under the rule. Compliance officers do not guarantee compliance with rules and regulations. Instead, a compliance officer is responsible for making sure that policies and procedures are established, reviewed for adequacy and effectiveness, and tested for compliance purposes. Compliance with policies and procedures is not the sole responsibility of compliance officers, however. In recent public statements, SEC staff members have indicated that other investment advisory employees, such as business personnel, can, and in some cases should, also be responsible for compliance matters.[4]

We are concerned that certain provisions in the interim final rule could be interpreted as expanding the scope of a compliance officer's responsibilities beyond the requirements set forth in the Advisers Act, including the interim final rule provisions mandating that an investment adviser's policies and procedures be "fair and equitable to all accounts participating in its cross-trading program" and mandating that an investment adviser's policies and procedures include a requirement that the investment adviser "allocate cross trades among accounts in an objective and equitable manner." Although the wording of the interim final rule is similar to the PPA requirement that an investment adviser adopt and engage in cross trades in accordance with "written cross-trading policies and procedures that are fair and equitable to all accounts," the manner in which this is addressed in the interim final rule could be interpreted as being significantly more expansive than the comparatively narrow focus of the Advisers Act on the adequacy and effectiveness of an adviser's policies and procedures.

The Advisers Act requires an investment adviser to adopt policies and procedures that are ***reasonably designed*** to be fair and equitable or ***reasonably designed*** to ensure the allocation of cross trades among accounts in an objective and equitable manner. The

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3 In that respect, "affiliate" should be defined to include any entity controlling, controlled by, or under common control with the investment manager.

4 For example, Gene Gohlke, Associate Director, SEC Office of Compliance, Inspections and Examinations, recently stated that based on examinations of the annual review process conducted by the SEC staff last year, larger investment advisory firms seem to be relying too much on the Chief Compliance Officer to conduct annual reviews. Instead, according to Mr. Gohlke, it may be more effective to have business personnel at a firm more involved in the annual review process. *See* CCO Outreach National Seminar webcast (Nov. 14, 2006) at http://www.connectlive.com/events/secoutreach111406/.

interim final rule could be interpreted as requiring an investment adviser to adopt policies and procedures that are fair and equitable, somehow guaranteeing perfection. As such, the language of the interim final rule would suggest that there would never be a situation in which an investment adviser, in the course of reviewing policies and procedures, could make a determination that a trade was not allocated in a fair and equitable manner and correct the situation. The interim final rule thus also would be inherently inconsistent with the requirement set forth in the PPA that the compliance officer must provide, on an annual basis, a written report describing the level of compliance with the investment adviser's policies and procedures, and any specific instances of noncompliance. Accordingly, we suggest that the Department clarify that the interim final rule requires an investment adviser to adopt policies and procedures that are reasonably designed to be fair and equitable or reasonably designed to ensure the allocation of cross trades among accounts in an objective and equitable manner.

Further, we suggest that the Department clarify that the interim final rule does not expand the scope of a compliance officer's responsibilities beyond the requirements set forth in the Advisers Act. At a minimum, the Department should clarify that the compliance officer is not required to certify every cross-trade transaction. Instead, the compliance officer can "periodically review" purchases and sales, as set forth in the PPA, in order to focus on the adequacy of policies and procedures. In addition, the Department should clarify that the compliance officer can rely on others to evaluate the consistency of cross-trade transactions with policies and procedures, based on a review of a sample number of transactions, in order to provide reasonable assurances that the policies and procedures are being followed on a consistent basis.

In the interim final rule, the Department also asks for comment regarding "whether the scope of the compliance officer's responsibilities under the regulation should be expanded to encompass compliance with all of the requirements of the statutory exemption." The interim final rule provides that the standards set forth in the rule "apply solely for purposes of determining whether an investment manager's written policies and procedures satisfy the content requirements of section 408(b)(19)(H) of the [PPA]."[5] Any expansion of a compliance officer's responsibilities as posited by the Department's request for comment would be inconsistent with a compliance officer's responsibilities under the Advisers Act. The compliance officer's review should be limited to the adviser's compliance with policies and procedures required by section 408(B)(19)(H) of the PPA.

[5] Section 408(b) (19) (H) of the PPA sets forth one of the conditions applicable to the cross-trade exemption. Specifically, it requires that "the investment adviser has adopted, and cross-trades are effected in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program, and that include a description of the manager's pricing policies and procedures, and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program."

III. The Interim Final Rule Should be Revised to Modify the Procedures for Compliance With the Minimum Asset Size Requirement of the PPA

The interim final rule requires a description of the procedures for ensuring compliance with the $100,000,000 minimum asset size requirement of the PPA. According to the interim final rule, "a plan or master trust will satisfy the minimum asset size requirement as to a transaction if it satisfies the requirement upon its initial participation in the cross-trading program and on a quarterly basis thereafter."

The IAA appreciates that the Department addressed the timing of determining the minimum threshold requirement in the interim final rule. While we agree that a plan or master trust should be required to satisfy the requirement upon its initial participation in the program, we respectfully suggest that monitoring should be done on an annual basis, and not a quarterly basis. Quarterly monitoring of a plan's asset size would be burdensome, expensive, and unnecessary. Presumably, the $100 million threshold was included in the PPA because a determination was made that at that level, plan fiduciaries would have the sophistication necessary to monitor cross-trade transactions executed on behalf of the plan.[6] A plan fiduciary, however, does not become less sophisticated if the plan dips below the $100 million threshold during the course of the one-year period.

In addition, quarterly monitoring adds another layer of bureaucracy for investment advisers without adding any benefit to ERISA plans. Investment advisers typically do not have information about the entire size of a plan since their role often is limited to managing part of a plan. Therefore, pursuant to the interim final rule, many investment advisers would be required to get quarterly certification of the plan's size from the sponsor or custodian. Such certification would be burdensome and expensive for both the investment adviser and the plan sponsor.

IV. The Department Should Implement Recommendations Made by the ERISA Advisory Council Working Group to the Secretary of the Department

The IAA respectfully requests that the Department implement cross-trading recommendations made to the Secretary of the Department by the EAC Working Group in November 2006. After considering testimony from a number of organizations, the EAC Working Group made several recommendations to the Secretary. We appreciate that the Department addressed one of the recommendations for the Department to provide guidance regarding circumstances in which assets may fluctuate above and below the $100 million threshold established by the PPA. Other recommendations made by the EAC Working Group include extending exemptive relief: (1) to allow cross trading by plans meeting a $50 million threshold; (2) to allow cross trading by pooled funds with at least one investor meeting the minimum asset size; and (3) to allow cross trades between

[6] As noted in prior correspondence and testimony, the IAA has advocated that absent any such threshold, there are fiduciary standards and numerous regulatory safeguards in place to provide protection to all plans, regardless of size.

plans maintained by employers in the same Controlled Group provided that ERISA plans within the same Controlled Group meet, in the aggregate, the minimum threshold requirements.

V. Conclusion

We appreciate the opportunity to provide our views on these important issues and would be pleased to provide any additional information the Department or its staff may request. Please do not hesitate to contact the undersigned if the Department or its staff has any questions regarding these matters.

Respectfully submitted,

Valerie Baruch

Valerie Baruch
Assistant General Counsel
Investment Adviser Association

April 24, 2007

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Dear Chairman Cox:

Several weeks have passed since the U.S. Court of Appeals for the District of Columbia Circuit overturned the Commission's fee-based brokerage account rule. While this decision may cause temporary disruption, we believe it also presents an opportunity for the Commission to develop a more rational, pro-investor policy for regulation of investment services providers. We are writing to urge the Commission: 1) provide guidance to brokers on their obligations and information to investors about the implications of the court decision while a more permanent policy is being developed; and 2) to reaffirm pro-investor aspects of the rule that were not overturned by the court ruling.

Because the entire rule is vacated by the decision, the governing law would – absent appeal – revert to the pre-1999 landscape, whereby brokers providing advisory services are exempt from the Advisers Act if they do not charge special compensation (e.g., fees) and the advisory services they provide are solely incidental to their brokerage services. The SEC retains its authority to interpret this existing exemption, including the meaning of the phrase "solely incidental." We urge the Commission to continue the position adopted in the vacated rule that discretionary management and financial planning services are not solely incidental to brokerage services. We further urge the Commission to interpret the existing exemption such that non-discretionary advice bearing the core characteristics of investment advisory services is not deemed to be solely incidental to brokerage services. This includes relationships of trust and confidence (from the client's perspective, not the broker's), ongoing supervisory or managerial services, portfolio management, asset allocation services, and advice regarding selection of investment advisers.

A long-term response to the Court decision will require complex decisions about a variety of issues, including how best to draw a functional distinction between brokers and investment advisers, determining the appropriate standards to apply to the range of activities engaged in by investment services providers, how to educate investors to make informed choices among the various types of providers, and what disclosures are appropriate to inform investors of the differing roles of these providers and of the applicable legal protections. We look forward to working with you to resolve these issues. In the meantime, we believe the steps outlined above would help to ease the transition and set the Commission on the path toward developing a policy that will both make sense to investors and provide them with appropriate protections.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America (CFA)

Duane Thompson
Managing Director of Washington Office
Financial Planning Association (FPA)

Mercer Bullard
President
Fund Democracy, Inc.

David G. Tittsworth
Executive Director
Investment Adviser Association (IAA)

Ellen Turf
Chief Executive Officer
National Association of Personal Financial Advisors (NAPFA)

Joseph P. Borg
President
North American Securities Administrators Association (NASAA)

INVESTMENT ADVISER
ASSOCIATION

May 29, 2007

By electronic mail

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Interagency Proposal for Model Privacy Form Under Gramm-Leach-Bliley Act, Rel No. IA-2598, File No. S7-09-07

Dear Ms. Morris:

The Investment Adviser Association[1] welcomes the opportunity to comment on the Securities and Exchange Commission's proposed model privacy form and accompanying amendments to Regulation S-P.[2] The Commission issued the proposal jointly with seven other federal regulators to implement a federal law requiring these agencies to develop a model privacy form compliant with the Gramm-Leach-Bliley Act privacy provisions that would be clear and comprehensible to consumers.

The IAA supports the SEC's goal to make privacy notices more clear, comprehensible, and easily readable. However, we have serious reservations about the proposal as framed. While we recognize the conceptual appeal of making such notices comparable across the financial services industry, we are concerned that the proposal may sacrifice the accuracy and quality of the information provided to consumers. More specifically, we submit the following comments and recommendations:

1. The IAA generally supports a safe harbor for use of the model privacy form subject to the important modifications set forth below.
2. The SEC should not withdraw its guidance with respect to the Sample Clauses currently in widespread use among SEC-registered investment advisers.
3. The model form is too rigid to be accurate for all entities and should be modified in the following respects:

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *Interagency Proposal for Model Privacy Form Under the Gramm-Leach-Bliley Act; Proposed Rule*, Rel. No. IA-2598, 72 Fed. Reg. 14940 (Mar. 29, 2007) ("Proposal").

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   a. Firms should be permitted to customize the form to ensure that the content accurately reflects each firm's actual information collection and sharing practices and information safeguards; and
   b. Firms should be permitted to omit certain terms in the model privacy form that do not apply to their information collection practices or their sources of information.
4. The format of the proposed form should be flexible enough to permit delivery on different size paper and presentation materials, through a number of methods, and included in various documents sent to clients.
5. The Commission has underestimated the costs to advisers of developing, maintaining, and delivering the proposed model privacy form.
6. The Commission should consider providing a streamlined annual notice option for situations where the firm: (1) shares and uses nonpublic personal financial information only in ways that do not trigger an opt-out right; and (2) has not materially amended its privacy policy during the preceding year.
7. The Commission should not amend its current rule governing delivery of revised privacy notices.

Background

In 2000, the SEC adopted Regulation S-P, which implemented privacy notice requirements and restrictions on sharing consumer information as mandated by the Gramm-Leach-Bliley Act.[3] Regulation S-P requires financial institutions, including all SEC-registered investment advisers, to adopt policies and procedures that are reasonably designed to protect the security and confidentiality of consumer records. The rule also requires an investment adviser to provide an initial notice of its privacy policy and practice upon entering into a customer relationship and prior to disclosing nonpublic personal information about a consumer to a nonaffiliated third party. Advisers are required to deliver annual notices to customers with whom an ongoing relationship exists and to permit customers, via an opt-out notice, to prevent disclosure of nonpublic personal information to certain nonaffiliated third parties. Compliance with Regulation S-P was mandatory as of July 1, 2001. On October 13, 2006, the Financial Services Regulatory Relief Act of 2006 was enacted, requiring certain agencies to develop jointly a model privacy form that is succinct, easily readable, and comprehensible to consumers.[4] This current proposal is the result of those efforts.

As the SEC recognized in the Regulation S-P proposing release, due to the fiduciary relationship between an investment adviser and its client, investment advisers

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[3] *See Privacy of Consumer Financial Information (Regulation S-P)*, Final Rule, SEC Rel. No. IA-1883, File No. S7-6-00 (Jun. 22, 2000).

[4] Pub. L. 109-351 (Oct. 13, 2006), 120 Stat.1966.

generally do not disclose client information to other parties.[5] Further, thousands of investment advisory firms are not affiliated with any other financial institution.[6] Accordingly, many investment advisers use the Sample Clauses provided as guidance by the SEC in Appendix A to Regulation S-P. These advisers have relied upon the Sample Clauses because they accurately and sufficiently describe their privacy policies and practices. As noted below, it would be counterproductive to remove the Sample Clauses simply due to the development of a model privacy form. We understand the Sample Clauses are working well for thousands of investment adviser firms that are not affiliated with other entities and that do not share consumer records with third parties other than as permitted by law.

1. **The IAA generally supports a safe harbor for a Model Privacy Form.**

Unlike other financial institution regulators, the SEC did not previously establish a safe harbor for the use of certain language in privacy notices; we commend the Commission for proposing to do so at this time.[7] Thus, we support the proposed provision stating that use of the model form "constitutes compliance with the notice content requirements of [Regulation S-P] although use of the [form] is not required." Establishing a safe harbor may serve as a useful incentive for financial services firms to adopt a model privacy form.

Although, as discussed below, the model form may not provide accurate information as currently proposed, a model form with more flexibility may provide efficiencies for large financial institutions and comparability across services and products for consumers. Investment advisory firms that are part of larger financial complexes appreciate the opportunity to be able to deliver the same privacy disclosures in a uniform way to their clients. These financial institutions may include investment advisers, brokers, banks, mutual funds, or custodians. It would be efficient for such institutions to use one notice applicable to all accounts at each firm, if feasible. To that end, an adviser and an affiliated institution regulated by another agency should be able to choose to rely either on the SEC model privacy form or the model privacy form proposed by the other agency.[8]

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[5] *Privacy of Consumer Financial Information,* SEC Rel. No. IA-1856, 65 Fed. Reg. 12354, at 12366 (Mar. 8, 2000).

[6] *See Evolution/Revolution 2006: A Profile of the Investment Adviser Profession* at 10 (stating that approximately 42% (4,369) of all investment advisers are not affiliated with any other financial industry entity) (available at www.investmentadviser.org).

[7] The IAA (then ICAA) also supported the concept of a safe harbor in its comment letter regarding proposed Regulation S-P. *See Letter from David Tittsworth, Executive Director, ICAA, to Jonathan G. Katz, Secretary, SEC* (Mar. 31, 2000).

[8] *See* Proposal, 72 Fed. Reg. at 14956 (requesting comment on this issue). Similarly, unaffiliated financial institutions currently have the ability under Regulation S-P and other Gramm-Leach-Bliley regulations to provide joint notices. *See* Regulation S-P, sections 248.9(f) and (g). Unaffiliated financial institutions should be permitted to use a joint model privacy form under the pending proposal as well.

2. The SEC should not withdraw its guidance regarding Sample Clauses.

The Commission proposes to use the model privacy form to replace the Sample Clauses currently found in Appendix A of Regulation S-P. The Commission states that "[r]esearch to date indicates that the language in the Sample Clauses is confusing, and accordingly, the Agencies propose to eliminate the Sample Clauses from the privacy rule."[9] Many advisers, particularly smaller advisers with no affiliates, adopted the Sample Clauses for their privacy notices. Indeed, advisers that use the Sample Clauses have been able to create notices that are more succinct and simplified than the model privacy form currently proposed by the agencies. It will be burdensome and unnecessary for small advisers to change their notices, particularly when they do not share information other than routinely to service their clients' accounts. Removal of the Sample Clauses would also leave advisers that choose not to use the model form with insufficient guidance in developing their notices. Accordingly, we request the Commission to retain the Sample Clauses currently permitted under Regulation S-P.

At a minimum, the Commission should withdraw the statement in the proposing release that research "indicates" that the Sample Clauses are "confusing." The proposal provides no explanation or citation as to why the language the Commission adopted in 2000 is now deemed to be confusing. We respectfully submit that the Sample Clauses as tailored by advisers are more accurate than the standardized language currently proposed. The Commission's statement may call into question the validity of firms' current and continued use of the Sample Clauses. Thus, there will be a strong disincentive to continue using existing and accurate disclosures relied upon by advisers and their clients alike for more than six years.

The Commission requests comment whether to retain Sample Clauses A-1, A-3, and A-7, or develop model clauses to replace those sample clauses for use as a safe harbor for firms that provide the simplified notice described in section 248.6(c)(5). The simplified notice provision permits certain advisers to simply state that they do not disclose nonpublic personal information to affiliates or nonaffiliated third parties except as permitted by law. We strongly recommend maintaining the viability of this provision by retaining the Sample Clauses.

If the Commission nevertheless determines to eliminate the Sample Clauses from Regulation S-P, we respectfully request additional transition time to continue to rely on the Sample Clauses for existing clients. We understand that for advisers with certain delivery cycles, a minimum of fifteen months transition time would be required.

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[9] Proposal, 72 Fed. Reg. at 14955.

3. Requirements for the Model Privacy Form must be sufficiently flexible to be *accurate* for each adviser.

The Commission has requested comment regarding whether the standardized provisions and vocabulary in the proposed model form are sufficient to allow firms accurately to disclose their information sharing and collection practices. We respectfully submit that the standardized language is not flexible enough to permit accurate disclosure of investment advisers' practices. We have serious concerns about the SEC's development of a form to be used in order to achieve a disclosure safe harbor where some of the form's language may be inaccurate or unclear to clients, yet cannot be altered according to the terms of the proposed rule. For example:

- The box on proposed page 2 describing how the financial institution collects personal information is so inaccurate for most investment advisers as to be misleading. For example, the sentence stating "[w]e also collect your personal information from others, such as credit bureaus, affiliates, or other companies" is simply inapplicable to many investment advisers. Thousands of advisers have no affiliates and require no credit reports. Credit bureau information is generally unnecessary for financial relationships that involve no use of credit, such as traditional investment advisory relationships. Similarly, investment advisers typically do not make loans and do not take payment in the form of credit or debit cards and therefore do *not* collect information from clients when they "apply for a loan" or "use [a] credit or debit card."
- The language on page two of the notice also states that the financial institution uses security measures that comply with federal law including "computer safeguards and secured files and buildings." Regulation S-P is flexible in requiring investment advisers to have policies reasonably designed to safeguard client information and does not specifically require "secured files and buildings." We suggest permitting insertion of the word "may" before the word "include." Alternatively, it would be helpful for consumers if advisers could provide their own example of what such security measures include. Otherwise, the disclosure of every institution is identical and consumers have nothing to compare among firms.
- Other generic financial institution phrases sprinkled throughout the form are inapplicable to advisers, including information about how customers "pay their bills," "use debit or credit cards," "credit history," "credit scores," "credit bureaus," and "creditworthiness."
- The "what?" box on page one contains the sentence: "When you close your account, we continue to share information about you according to our policies." This is simply inaccurate and misleading for the vast majority of advisers, who will not "continue to share information" after the advisory relationship ends. A more accurate sentence is: "We will protect the information of our former clients to the same extent as our current clients." The SEC's current guidance is also more accurate: "If you decide to close your account(s) or become an inactive

> customer, we will adhere to the privacy policies and practices as described in this notice."

Compounding these inaccurate statements is the statement in the first box on page one: "Please read this notice carefully to understand what *we* do" (emphasis added). There is similar language in the boxes on page two. However, this form does not inform clients about what the particular adviser does – it merely informs clients what advisers, brokers, investment companies, and other entities generically may do. Similarly, the header for the first set of boxes on page two reads: "Sharing practices." However, nothing in this set of boxes informs the client of the adviser's sharing practices.

We strongly submit that investment advisers should be able to customize the information in the applicable boxes. This would assist consumers in more readily comparing various financial institutions' practices, rather than cause confusion. The boilerplate approach provides virtually no information to consumers, except with respect to sharing among affiliates and non-affiliates for other than everyday business purposes. If the Commission does not permit customization, we recommend permitting the use of phrases more appropriately applicable to investment advisers. For example, in the "what" box on page one, information collected may include home address, telephone number, financial information, investment objectives, and transaction and holdings information.[10] The SEC could provide appropriate alternatives that varying financial institutions could elect to use, as appropriate to their firms.[11]

The Commission has also requested comment on whether firms should be permitted to omit terms that do not apply to their information collection practices or their sources of information. Omitting such terms would help streamline the model form and increase client comprehension. And, if the Commission does not permit customized answers, we strongly recommend that firms be permitted to omit inapplicable terms. Omission of inapplicable terms would then be the only method by which firms could avoid distributing inaccurate or misleading notices to consumers.

4. The format of the proposed form should be more flexible.

As proposed, the format and delivery of the model privacy form is too rigid. The proposal presents no compelling reason for using 8.5x11 paper other than the statement that interviewers chose to use that size paper and interviewees liked it.[12] In addition,

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[10] The Commission could also include an "other" box which could be checked by firms and include anything else distinctive applicable to their particular businesses.

[11] Another benefit of flexibility arises from the need of global firms to comply with privacy disclosure requirements that vary by jurisdiction. Advisers should be permitted to include in their notices more specific information collected (e.g. mother's maiden name) as appropriate to comply with privacy requirements imposed by the European Union, U.K. Financial Services Authority, or other jurisdictions.

[12] It is not clear from the proposal whether interviewees received the privacy policy as a stand-alone document or whether they were provided a more realistic experience, such as opening an envelope with a

prohibiting the notice from being incorporated into any other document is too limiting and substantially raises the cost for advisers to prepare and deliver the notices. Many organizations, including the federal government, deliver important information to citizens regularly on various sized paper in many formats. We strongly recommend more flexibility in the format of the document, such as permitting the use of firms' logos, colored inks, colored paper and various sizes of paper. Advisers should also be permitted to add administrative information to the form, such as an effective date or revision date, document codes, and bar codes on the opt-out form. Further, we specifically encourage the SEC to permit a tri-fold brochure that could provide the model privacy form on three facing pages.

We also recommend more flexibility with respect to electronic delivery, web site availability, and including the disclosures in other documents prepared by the financial institution. The Regulation S-P delivery provisions currently provide flexibility in delivery of notices that include permitting personal delivery, mail delivery, and electronic delivery.[13] Advisers use and deliver privacy notices in many formats on paper and through electronic media. These alternatives should be preserved to the extent possible including the use of web site notices, electronic delivery, and acknowledgements for notices delivered electronically in connection with electronic delivery of advisory services. Advisers should also be permitted to continue to include their privacy notices as part of their investment adviser brochures and Form ADV and its required disclosures, all as currently permitted under Regulation S-P.[14]

Further, the Commission should provide additional flexibility regarding how firms may identify entities (both affiliated and unaffiliated)[15] that are providing a joint notice. For example, advisers should have the opportunity to use a short form name or group of names throughout the form, while more specifically identifying the companies covered in a legend or footnote the first time the name of the financial institution is required.

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complete set of account opening materials. One adviser's market research suggests that in this latter scenario, clients did not prefer to receive multiple separate sheets of paper.

[13] Regulation S-P, section 248.9.

[14] *See Staff Responses to Questions about Regulation S-P, updated as of Jan. 23, 2003*, available at www.sec.gov/divisions/investment/guidance/regs2qa.htm. These interpretations permit advisers to include privacy notices in other documents given to clients, such as brochures, Form ADV Part II , and other methods.

[15] *See* n.8, *supra.*

5. The Commission has underestimated the costs of implementing the Model Privacy Form.

The Commission states that firms electing to use the model privacy form "could incur some small incremental costs" in changing from existing notices to the new form.[16] To deliver these notices annually to all customers on two or three separate sheets of paper, rather than one booklet or brochure or incorporating the notice into other documents, will needlessly add significant costs to current preparation and delivery expenses both initially and on an ongoing basis. Initially, advisers will incur the cost of re-writing their disclosure, reviewing revised notices internally and with counsel, republishing brochures or notices, reprinting, and delivery. In addition, advisers will have to revise and reprint any documents that currently incorporate the privacy notice (*e.g.* Form ADV).

We have gathered information from larger investment advisory firms and their affiliates indicating that the additional cost of printing and mailing the model privacy form alone could range from $100,000 to more than $300,000 per mailing. Such firms estimate a range from $.09 for printing and mailing the two-page model form to $.24 per package for a three-page form. Some estimates project an additional flat charge of $300-$1,500 per lot depending on quantity. These estimates do not include reprinting and revising other forms that currently include the privacy notice.

Further, the Commission's cost estimates do not account for revising or preparing new explanatory material for employees and re-training employees regarding the new form. Some advisers may incur costs in preparing scripts and responses for call centers charged with responding to questions from clients who may be confused by the new form.[17]

Given that investment advisory firms have not experienced significant client complaints about the privacy notices, it is not likely that the benefits of using the proposed model form would outweigh the costs either for advisers or their clients.

6. The Commission should consider permitting firms to deliver a streamlined annual notice.

Many investment advisers do not share non-public personal financial information other than as permitted without triggering opt-out rights and make no material changes in their policies year to year. The Commission should consider permitting firms to use a short abbreviated disclosure that would simply convey to clients that the firm's policies

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[16] Proposal, 72 Fed. Reg. at 14959.

[17] One financial services firm's estimate of the cost of responding to each such call is $.75 per minute. Assuming a five-minute call at $3.75 per call, such costs could add up significantly for a large entity that mails hundreds of thousands of notices, even if only a small fraction of clients place phone calls.

and procedures have not changed during the past year. The notice could refer clients to the firm's web site for the full privacy policy or provide information regarding how clients could request a copy of the firm's full policy. The Commission could permit this annual notice to be included prominently in other documents given to customers during the year.

Advisers are required by Regulation S-P to provide each client a full privacy notice when the client establishes a relationship with the adviser. If there are no changes during the year, the firm has no new information to convey to clients except that the financial institution continues to keep confidential all customer personal financial information. Under these circumstances, providing a full-blown two-page model privacy form annually is excessive, and not particularly helpful, for both the customer and the financial institution. The SEC should prepare a short text box that advisers meeting the conditions could use to comply with the annual privacy notice, either separately or within another document.

7. The Commission should not amend its current rule governing delivery of revised privacy notices.

The Commission has asked for comment about whether financial institutions should be required to alert clients to changes in an institution's practices as part of the model form regulations. Regulation S-P currently requires delivery of a revised notice if the firm intends to disclose a new category of nonpublic personal information to any nonaffiliated third party, disclose such information to a new category of nonaffiliated third party, or disclose such information about a former client to a nonaffiliated third party if the former client has not had the opportunity to opt-out regarding that disclosure.[18]

This rule is sufficiently clear and robust to protect consumers' nonpublic personal information against unannounced changes in privacy practices and procedures. Thus, we respectfully submit that this aspect of the rule does not need to be changed.

[18] Regulation S-P, section 248.8.

Conclusion

We appreciate the opportunity to provide our views on these important issues and would be pleased to provide any additional information the Commission or its staff may request. Please do not hesitate to contact Paul Glenn, IAA Counsel, or the undersigned with any questions regarding these matters.

Respectfully submitted,

Karen L. Barr

Karen L. Barr
General Counsel

Cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
The Honorable Kathleen L. Casey

Mr. Andrew J. Donohue, Director, Division of Investment Management
Mr. Robert E. Plaze, Associate Director, Division of Investment Management

INVESTMENT ADVISER
ASSOCIATION

June 20, 2007

By electronic mail

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
Authorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Nunavut
Registrar of Securities, Yukon Territory

c/o John Stevenson, Secretary
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and

Madame Anne-Marie Beaudoin
Directrice du secrétariat
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Re: National Instrument 31-103 Registration Requirements

Dear Mr. Stevenson and Madame Beaudoin:

The Investment Adviser Association[1] (IAA) welcomes the opportunity to comment on the proposed National Instrument 31-103 "Registration Requirements" (the Rule) together with its companion policy 31-103 (the Companion Policy)(together, the Proposed Instrument) issued by the Canadian Securities Administrators (CSA) regarding the registration of investment advisers in Canada.[2]

We commend the CSA for considering these important issues and appreciate the opportunity to provide input regarding the Proposed Instrument. The IAA supports the effort to harmonize registration requirements across all CSA jurisdictions. We support the modernization of the registration process in Canada for investment advisers. However, we have several concerns and recommendations regarding the proposal, particularly as to the effect of the proposal on foreign investment advisers with clients in Canada. More specifically, we submit the following comments and recommendations:

1. The IAA supports a uniform approach to investment adviser registration in Canada.
2. The IAA recommends additional clarifications or revisions with respect to the exemptions for international advisers, including:
    - Provide a clear *de minimis* standard;
    - Expand the list of permitted clients; and
    - Eliminate the condition prohibiting solicitation of new permitted clients, or, at a minimum, clarify that certain types of conduct do not constitute solicitation for purposes of the exemption.
3. The IAA recommends clarification that international sub-advisers may have "contacts" with clients without losing their exemption from registration.
4. The IAA urges the CSA to revise the Proposed Instrument to:
    - Expand the transition process and implementing time period of the proposed law;
    - Enable the entire registration process to be accomplished electronically;

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association based in Washington DC that represents the interests of investment advisers registered with the Securities and Exchange Commission. Founded in 1937, the Association's membership consists of about 500 firms that collectively manage in excess of US$8 trillion in assets for a wide variety of individual and institutional clients. The IAA's membership includes a number of Canadian-based investment advisory firms as well as U.S.-based firms that conduct investment advisory activities in Canada, as international advisers or through affiliates providing investment management services to Canadian clients. For more information about the IAA, please visit our web site: www.investmentadviser.org.

[2] This letter highlights the interests of our members who are all SEC-registered investment advisers, in the United States and elsewhere, including several headquartered in Canada or licensed in various Canadian provinces.

- Clarify permitted practices involving transfers of licenses, changes of ownership, and newly-exempted advisers; and
- Clarify the establishment and residency limitations for the categories of international portfolio manager and international investment fund manager.

Background

The Proposed Instrument is the latest in a series of initiatives to streamline and modernize the regulation of securities in Canada. Commendably, the most recent effort has attempted to address the interests of the CSA, self-regulatory organizations, and industry. The Proposed Instrument is intended for implementation by each of the CSA members following introduction and passage of enabling legislation by the provincial legislative body in each of the 13 Canadian jurisdictions. While this format is intended to lead to increased uniformity, harmony, and consistency, the Proposed Instrument would still involve 13 separate sets of laws, registrations, and administrative bodies. We believe this effort would fall short of the expected efficiencies of a pan-Canadian federal legislative solution that would transcend the provinces and territories and create one national registration applicable to all of Canada.

1. The IAA supports a uniform approach to investment adviser registration in Canada.

The IAA commends the CSA for undertaking such a comprehensive effort to streamline and modernize the investment adviser laws in Canada. Creating a single registration form for investment advisers that would apply to each jurisdiction is a significant step forward. We applaud the proposed arrangement whereby an adviser registered in multiple provinces could effectively deal with a “principal regulator” instead of interfacing with agencies in all 13 jurisdictions with respect to varying forms, time periods, details, and distinctive legal characteristics. Further, we would encourage the appropriate legislators and regulators to adopt the whole measure as presented at the appropriate time and to resist the temptation to retain any distinctive local rules or variations.

Given the increasing globalization of the asset management industry, we cannot overstate the need for consistency with respect to the regulatory frameworks for the registration of investment advisers in Canada, the United States, the United Kingdom, and the European Union. Many investment advisers are subject to regulation in each jurisdiction and are subject to inconsistent and potentially conflicting regulatory standards. It is increasingly difficult, time-consuming, and expensive for advisers to address the compliance requirements of disparate regulatory regimes. The IAA has long emphasized that securities regulators should work together to encourage uniformity in the approach to rules relating to investment advisers with clients in several different countries so they can better operate under consistent regulatory frameworks.

2. **The IAA recommends additional clarifications or revisions with respect to exemptions for international advisers.**

De minimis standard. We recommend that the CSA establish a clear threshold below which foreign advisers with a certain number of Canadian clients need not register as investment advisers in Canada. The newly proposed categories and standards provide certain exemptions from the registration requirements, but an additional objective *de minimis* exemption would be helpful so that an adviser with, for example, fewer than six Canadian clients, would not need to register in Canada provided that adviser is duly registered in the United States, United Kingdom, European Union, or other jurisdictions with comparable regulatory regimes. This exemption would cover the relatively common situation where an existing client of a U.S.-based and regulated investment adviser moves to Canada and the client would like to leave unchanged their asset management relationship. Such a *de minimis* exemption for foreign advisers could be applied similar to the present Ontario *de minimis* exemption,[3] although, as discussed further below, the list of "permitted clients" associated with such an exemption should track in its entirety the current list in the existing Ontario *de minimis* exemption. The Proposed Instrument, taken as a whole, should have this uniform provision and not resort to a patchwork of various *de minimis* standards applied separately in each province.

Permitted clients. We recommend that the list of permitted (exempt) clients for a foreign investment adviser mirror, at a minimum, the permitted clients under current Ontario rules, which allow for 14 different types of exempt clients. The Proposed Instrument unnecessarily restricts the list of types of permitted clients to seven. Some U.S-based investment advisers presently conduct certain activities for Canadian registered investment advisers, registered fund managers, and other "permitted clients" without the need for registration in Canada. *See* Ontario Securities Commission *Rule 35-502 Non-Resident Advisers*, Definitions Part 1.1. These activities include managing portions of clients' portfolios, making securities selection recommendations, and performing other advisory functions for registered Canadian investment advisers and other exempt clients. We encourage the CSA to retain such exemptions for foreign investment advisers, especially those that are registered and already regulated in jurisdictions such as the United States, the United Kingdom, and the European Union. We strongly suggest the CSA add to the list of "permitted clients" to match the list currently used in Ontario.[4] We understand that the Ontario exemption has worked well with relatively few problems.

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[3] *See Ontario Securities Commission Rule 35-502, Non-Resident Advisers*, Part 7, subpart 7.1 permitting a non-resident adviser an exemption from registration if the adviser, among other things, has not more than five clients in Canada (not counting exempted or permitted clients).

[4] Some of the categories omitted under the Proposed Instrument include (1) registered charities; (2) individuals with net worth exceeding $5 million; (3) companies owned only by individuals whose net worth exceed $5 million; and (4) corporations with at least $100 million of shareholders' equity. If the Proposed

Solicitation. The Proposed Instrument should eliminate the condition in the exemption for international portfolio managers that the manager not solicit new clients in Canada.[5] At a minimum, we recommend clarification in the Companion Policy that informal (*i.e.* non-compensated) referrals of potential clients by existing clients or others do not constitute "solicitation" of clients in Canada. If a non-resident foreign-registered firm qualifies for a registration exception in Canada and advises only exempt clients, that firm's exempt filing status should not be jeopardized merely because the firm may enter into an advisory relationship with a new exempt client referred by an existing client or others. Similarly, if the adviser responds to a request for proposal (RFP) from a permitted investor or their representative or other inquiry from a consultant or prospective client, such response should not be deemed a solicitation in Canada. There appears to be some disharmony between the philosophy of exemptions based on permitted clients and the concept of not allowing firms to obtain new permitted clients. The Proposed Instrument should be clarified or amended to either permit solicitation of additional permitted clients or clearly explain that non-compensated referrals or responses to RFPs or similar types of contacts do not constitute solicitations.

3. The IAA recommends clarification that international sub-advisers may have "contacts" with clients without losing their exemption from registration.

The Proposed Instrument should be clarified to provide that sub-advisers would not violate section 9.17(e) by making routine client servicing contacts. Section 9.17(e) provides that for a sub-adviser to be exempt from registration, … "the person or company so acting as an adviser has *no direct contact* with the registrant's client unless the *registrant is present*" (emphasis added).

The Companion Policy should confirm that if an advisory firm is responding to any questions from its clients (or their consultants), including clients of a Canadian fund or Canadian adviser that may be sub-advised, those responses and answers should be permitted without being considered direct contacts by the adviser. The foreign adviser should be able to respond to questions from Canadian investors without the requirement of the Canadian registrant being "present." Any written responses could be copied to the Canadian advisory firm, if Canadian authorities deem that important, but additional impediments to contacting the sub-adviser might be disadvantageous to Canadian investors in getting prompt answers to questions they may seek.

Instrument does not mirror the Ontario exemption, the CSA should provide clarity regarding any grandfathering or transition provisions for those advisers presently relying on Ontario's more expanded list of permitted clients.

[5] Proposed Instrument; Rule section 9.14(2)(b).

4. **The IAA suggests the following additional modifications to enhance the Proposed Instrument.**

- **The CSA should expand the transition process and implementing time period of the proposed law.**

The IAA encourages the CSA to provide additional information about the process of transitioning from the current arrangement to the new model under the proposed new registration regime. It is unclear how registrants under the old scheme should proceed in the various jurisdictions while the new regime is put in place or how advisory firms would either migrate their registration, let their old registration lapse upon a new filing, or transition from relying on a registration exemption to registering. The Proposed Instrument does not explain what firms that will no longer be required to register must file, such as a Proposed Notice of Termination on Form 33-109F1, or whether some other action would be required. In addition, advisers currently relying on an exemption but required to register under the new regime should be given assurance of being promptly registered or provided sufficient time to accommodate any transition or registration issues.

In this regard, the proposed 120-day transition period for the Proposed Instrument appears inadequate. We would suggest a one-year period (or more, such as 15 months) to better accommodate varying fiscal year-ends, reporting periods, changing literature, obtaining amended agreements, and other logistical considerations.

- **The CSA should enable the entire registration process to be accomplished electronically.**

The registration process in the Proposed Instrument provides a sound start for enabling and permitting registration of advisers through an electronic medium. We encourage the CSA to work further to enable and permit the entire filing process to take place electronically over the Internet for all those eligible to register, including foreign-based investment advisers. Under the Canadian National Registration System (NRS) a firm filer "*may elect*" to use the NRS system *if* the firm filer has a business office in Canada and is registered in at least one other jurisdiction. (Emphasis added). *See Ontario Securities Commission, National Instrument 31-101*, Part 2.1. Data for all filers, however, are collected as part of the National Registration Database (NRD). We recommend that the electronic registration process permit the registration of all advisers, including foreign advisers, to occur simultaneously in all selected provinces in one electronic filing session from whatever location the applicant applies. Paper supplements should be totally eliminated, or at the least minimized, and checks for fees should be replaced with an electronic equivalent.

We recommend reducing paperwork to the extent possible. The CSA should carefully consider some of the requirements in the proposal that mandate a registering investment adviser to provide voluminous and ever-changing materials (in paper copy presumably) such as Policies and Procedures Manuals, copies of all investment advisory agreements, and originally signed letters of direction to auditors authorizing future audits. Perhaps requiring an appropriate box-selection for affirming that the adviser has such records or agrees to provide such documents if requested in accordance with Canadian requirements would be sufficient for registration purposes. Documents could be required by the regulators upon the occasion of an inspection or examination at the adviser's premises. We do note positively the recommended change in the Proposed Instrument that would remove the "Canadian incorporation requirements" that needlessly complicate the registration process for foreign advisers.

- **The CSA should clarify permitted practices involving transfers of licenses, changes of ownership, and newly-exempted advisers.**

We note with favor that Canadian adviser registrations will be more "mobile" under the Proposed Instrument. Under the Proposed Instrument, registrations are perpetual and the transfer of a registration from one province to another can be made without affecting the adviser's registered status. Similarly, the adviser's registration may continue uninterrupted despite a change in name, change in ownership of the adviser firm, or change of principal Canadian regulator. These features are commendable, but the details relating to changes of control are not clearly defined. In regulatory schemes, the subject of change-of-control is often a carefully crafted concept that would typically include such items as what percent of ownership can change without triggering a change of control for registration purposes (*e.g.* 25 percent or less). This area warrants further consideration. The CSA should address questions such as

- Do the new owners or former owners have any filing responsibilities?
- What time periods apply for effectiveness of changes in control or registration?
- Is a simple notice of change in control sufficient?

- **The CSA should clarify the establishment and residency limitations for the categories of international portfolio manager and international investment fund manager.**

The Rule includes registration exemptions for international portfolio managers and international investment fund managers. To utilize the exemption, the international entity may not have an "establishment in Canada or officers, employees or agents resident in Canada." We suggest the CSA provide guidance clarifying what type of activity meets this requirement. For example, an adviser contracting with a consultant to market services on a part-time basis should not disqualify an entity from utilizing this exemption.

Conclusion

We appreciate the opportunity to provide our views on these important issues and would be pleased to provide any additional information the Canadian securities authorities or its staff may request. Please contact the undersigned with any questions regarding these matters at (202) 293-4222 or paul.glenn@investmentadviser.org.

Respectfully submitted,

Paul D. Glenn
Counsel

July 3, 2007

Via Electronic Mailing

Andrew J. Donohue
Director, Division of Investment Management
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Division of Investment Management Review of Investment Adviser Regulatory Issues

Dear Mr. Donohue:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Division of Investment Management's review of investment adviser regulations to assess whether they need to be updated, revised, or eliminated.[2] We agree it would be useful for the Division to review and update the rules applicable to investment advisers that may have outlived their effectiveness and usefulness due to the passage of time, product or market developments, and/or technological advancements.

We believe it is critical that the Division address several areas as part of this review, including re-proposing Form ADV, Part 2; streamlining the books and records requirements, incorporating e-mail guidance; modernizing the advertising rules and Commission staff no-action positions; granting relief from the unintended consequences of the custody rule; addressing soft dollar disclosure; clarifying requirements related to fee-based brokerage accounts; reviewing regulation of hedge fund advisers; and assessing

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *See* Andrew J. Donohue, "Remarks Before the IA Week and the Investment Adviser Association 9th Annual IA Compliance Best Practices Summit 2007," (Mar. 22, 2007) ("Summit Speech"), available at http://www.sec.gov/news/speech/2007/spch032207ajd.htm ("As time has passed and circumstances change, certain regulations may no longer be relevant or necessary or could be improved to adapt to modern practices. This year, and going forward on a regular basis, my staff and I will be reviewing the regulations governing both investment companies and investment advisers and considering whether any may need to be revised, updated or eliminated.") Areas of review identified included books and records; Form ADV, Part 2; investment adviser/broker-dealer study; and hedge fund initiatives. *See also,* Andrew J. Donohue, "Keynote Address at the Practicing Law Institute Investment Management Institute 2007" (Apr. 12, 2007) ("PLI Speech") (discussing review of regulatory inventory), available at http://www.sec.gov/news/speech/2007/spch041207ajd.htm.

the impact of regulatory changes on investment advisory firms. We address these issues below.

Form ADV, Part 2

In April 2000, the Commission proposed substantial revisions to Form ADV, the registration and disclosure form for investment advisers. During the months following the proposed rule, our organization worked closely with Division staff and others, including state regulators and NASD, in implementing electronic filing by all SEC-registered investment advisers of Form ADV, Part 1. We believe this important transition was successful and has resulted in unprecedented transparency of information relating to investment advisers.

However, the Commission has not yet finalized similar revisions for Part 2, the narrative brochure that, among other things, discloses how an investment adviser deals with potential conflicts of interest relating to personal trading, best execution, soft dollars, and other areas. We have communicated a number of concerns to the Commission staff regarding certain aspects of the Part 2 proposed revisions,[3] and we stand ready to answer any questions or to discuss options for resolving these concerns. We continue to believe that adoption of a final rule on Part 2 should be an important Division priority, particularly in light of the significant benefits that may be realized for investors, the Commission, and others, when these disclosures become readily available via the Investment Adviser Public Disclosure web site. We urge the Division to take prompt action to move forward with this important rule, although we recognize that developments during the last seven years will require a re-proposal for additional comment.

Books and Records / E-mail Retention and Production

You recently stated that the Division is undertaking a comprehensive review of the recordkeeping requirements for investment advisers, noting that "these rules are in great need of reform."[4] We agree. While we would have serious concerns about any proposal that would expand the current framework to require advisers to capture virtually all records, we wholeheartedly support the concept of modernizing the books and records rules. We have been encouraged by the Division's intention to "look at the purpose behind each requirement and determine whether we can obtain the same information in a more meaningful and less obtrusive manner."[5] We are pleased to continue to assist the

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[3] *See, e.g.*, Letters from Karen L. Barr, Investment Adviser Association to Jonathan Katz, Secretary (June 13, 2000 and May 24, 2001). All of our comment letters are available on our web site, www.investmentadviser.org, under "Comments & Statements."

[4] *See* PLI Speech, *supra* n. 2.

[5] PLI Speech.

Division in its review of the books and records rule and to provide additional feedback on this important initiative.

In addition, we understand that the Division staff is currently preparing guidance regarding the appropriate scope of the books and records rule as it relates to e-mail,[6] and we continue to support such guidance, either via a separate Commission rulemaking or interpretation or as part of the comprehensive effort to review the books and records rules.[7]

Advertising

In August 2001, the IAA submitted a proposal recommending substantial revisions to Rule 206(4)-1 governing investment adviser advertising under the Investment Advisers Act of 1940 (Advisers Act).[8] Our proposed changes would update and simplify the rule and make it more consistent with the original purposes of the anti-fraud provisions of Section 206 of the Act. The proposal would substantially enhance investor protections by improving the quantity and quality of the information provided to clients and prospective clients, as well as providing minimum standards governing composite performance results prepared for retail clients. When it became apparent that the Division staff did not intend to act promptly on the proposal, the IAA engaged in discussions with Division staff regarding interim relief. In 2004, Division staff granted partial interim relief,[9] and no further progress has been made.

We continue to believe that the adviser advertising rules are outdated and require significant amendments. To further assist the Division in considering these matters, we intend to submit an additional request for no-action or interpretive relief from certain aspects of the advertising rule in the near term. In light of the complexity of and confusion surrounding the advertising rule and related interpretations, as well as the importance of these issues to investors and the adviser profession, we strongly urge the Division to elevate the priority of addressing these matters.

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[6] *See* Summit Speech ("I know everyone could benefit from clear, e-mail specific guidance, and I have asked the Division staff to continue preparing such guidance.")

[7] *See* Letter from David G. Tittsworth, Investment Counsel Association of America to Paul F. Roye, Director, Division of Investment Management, and Lori A. Richards, Director, OCIE (Nov. 19, 2004).

[8] Letter from Karen L. Barr, Investment Adviser Association to Paul F. Roye, Director, Division of Investment Management (Aug. 21, 2001).

[9] No-Action Letter from Douglas Scheidt and Robert E. Plaze to Karen L. Barr, Investment Counsel Association of America (Mar. 1, 2004).

Custody Rule

Since the revised custody rule was adopted in 2004, we have engaged in a dialogue with Division staff regarding concerns about potential unintended consequences that may result from informal staff comments and language included in the Staff Responses to Questions about Amended Custody Rule.[10] In particular, we have sought clarification regarding an adviser's ability to forward to the client or the client's custodian checks that are drawn by a third party and made payable to a client, such as class action settlement funds and IRS refunds.[11] Further, we are concerned that the requirement to maintain client funds and securities with a qualified custodian should not eliminate the ability of an advisory firm to act under a power of attorney or other written form of client authorization to transfer funds and securities on behalf of a client. We urge the Division to address these issues promptly.

Soft Dollars

The IAA has been actively involved in ongoing discussions related to soft dollar issues for many years.[12] The IAA raised a number of concerns in response to the Commission's request for comment on its Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934.[13] In particular, the IAA expressed concern regarding the treatment of advisers' receipt of unsolicited products and services from brokers, as well as an implied proposed requirement to unbundle brokerage commissions. The IAA would be pleased to provide any additional information the Division may seek to address these concerns.

Recently, Chairman Cox requested Congress to consider legislation that would "repeal or substantially revise Section 28(e)."[14] We believe it is unlikely that Congress will repeal the soft dollar safe harbor, and we continue to urge the Commission to provide for full and appropriate disclosure of soft dollar practices and enhanced related

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[10] Staff Responses to Questions about Amended Custody Rule, available at http://www.sec.gov/divisions/investment/custody_faq.htm (updated as of Jan. 10, 2005).

[11] *See* Letter from Caroline G. Schaefer, Karen L. Barr, Investment Adviser Association to Robert E. Plaze, Associate Director, Jennifer L. Sawin, Assistant Director, Division of Investment Management (Nov. 18, 2004).

[12] *See, e.g.*, the IAA's March 3, 2004 statement on soft dollars and March 31, 2004 written Congressional testimony, which are available on our web site under "Comments & Statements."

[13] SEC Rel. No. 34-54165; File No. S7-13-06 (July 18, 2006); *see* Letter from Monique S. Botkin, Investment Adviser Association to Jonathan Katz, Secretary (Nov. 23, 2005).

[14] *See* Letters from the Honorable Christopher Cox to Sen. Christopher Dodd (May 17, 2007) and to Rep. Barney Frank (May 23, 2007).

recordkeeping requirements.[15] The IAA stands ready to assist the Commission in evaluating issues relating to the consideration of the soft dollar safe harbor and respectfully requests an opportunity to participate and present the views of our members should the Division consider an additional rulemaking in this area.

Fee-Based Brokerage Account Rule / Study of Investment Adviser and Broker-Dealer Regulatory Issues

The Commission's rulemaking relating to the broker-dealer exception under the Advisers Act was recently invalidated by the D.C. Circuit Court of Appeals.[16] The IAA has been actively involved in this rulemaking since its inception in 1999. In response to the court's ruling, we, along with other groups, urged the Commission to: (i) provide guidance to brokers on their obligations given the court's decision and information to investors about implications of the court decision while a more permanent policy is being developed; and (ii) reaffirm pro-investor aspects of the rule that were not overturned by the court.[17]

On May 14, 2007, the Commission announced it will consider whether further rulemaking or interpretations are necessary regarding the application of the Advisers Act to these accounts and the issues resulting from the court's decision.[18] The court recently granted the Commission's request for a four-month stay of the decision to October 1, 2007 to allow investors and brokers time to make informed decisions about transitioning out of fee-based brokerage accounts – either to commission-based brokerage accounts or fee-based advisory accounts. It is important that the Commission retain investor protections in whatever rulemaking or interpretation will be provided in response to the court's ruling.

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[15] The IAA's 2004 written Congressional testimony stated that, "[i]nvestment 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." The IAA also noted that, "[t]he consequences of abolishing soft dollars . . . 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 [IAA] strongly believes that a rulemaking is the best option for considering and implementing changes in this important area."

[16] *See Financial Planning Association v. S.E.C.*, 2007 WL 935733, C.A.D.C. (Mar. 30, 2007) (vacating Advisers Act rule 202(a)(11)-1 adopted in *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Rel. Nos. IA-2376; 34-51523; File No. S7-25-99 (Apr. 12, 2005)).

[17] *See* Letter from David G. Tittsworth, Investment Adviser Association, Consumer Federation of America, Financial Planning Association, Fund Democracy, National Association of Personal Financial Advisors, and North American Securities Administrators Association, to the Honorable Christopher Cox, Chairman (Apr. 24, 2007).

[18] *See* Press Release, "Commission Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts," May 14, 2007 ("Press Release").

Chairman Cox also announced that the RAND study of the marketing, sale, and delivery of financial products and services to investors in this area will be accelerated so that it is delivered to the Commission no later than December 2007.[19] He noted that the results of the study are expected to provide an "important empirical foundation for considering improvements" in this regulatory area.[20]

We have previously outlined some of our concerns related to the proposed study.[21] We believe it is crucial for the Commission to focus its resources on clarifying the distinctions between advisers, brokers and planners, on educating investors about these distinctions, and on protecting investors by enforcing the law in these areas. We would welcome the opportunity to work with you and your colleagues in connection with future rulemaking in this area or the RAND study and any ensuing Commission action related to these issues.

Regulation of Hedge Fund Advisers

Our organization supported the Commission's rulemaking requiring the registration of certain hedge fund advisers under the Advisers Act.[22] After the D.C. Circuit Court of Appeals vacated the rulemaking,[23] the Commission proposed anti-fraud rules under the Advisers Act for advisers to pooled investment vehicles and proposed to increase the accredited investor standards under the Securities Act of 1933 for investors in certain private investment vehicles.[24] In our comment letter, we requested the

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[19] *See* Press Release. When the Commission approved the final rule in April 2005, it also directed Commission staff to report on "any rulemaking action that the staff would be prepared to recommend that the Commission undertake in the near term, or to recommend that the Commission ask the NASD or other SROs to undertake in the near term" as well as options and recommendations for a study "to compare the levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act…" In June 2006, the Commission issued a Request for Information for "a study that will involve collecting, categorizing and analyzing empirical data regarding the marketing, sale, and delivery of financial products, accounts, programs and services offered to individual investors by broker-dealers and investment advisers." *Request for Information/Draft Solicitation,* SEC Rel. No. 34-54077 (June 30, 2006).

[20] Press Release.

[21] Letter from David G. Tittsworth, Investment Adviser Association to the Honorable William H. Donaldson (June 22, 2005).

[22] *See* Letter from David G. Tittsworth and Caroline Schaefer, Investment Counsel Association of America, to Jonathan B. Katz, Secretary (Sept. 14, 2004); *see also* Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan B. Katz, Secretary (July 7, 2003).

[23] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (vacating and remanding *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, SEC Rel. No. IA-2266, File No. S7-30-04 (Dec. 4, 2004)).

[24] *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles,* SEC Rel. No. 33-8766, IA-2576; File No. S7-25-06 (Dec. 27, 2006). *See also,*

Commission to adopt a fiduciary representative exception to the proposed accredited natural person standard for investors who hire an SEC-registered investment adviser as their financial proxy, among other requests.[25] We stand ready to assist the Commission and its staff to help ensure that hedge fund investors are protected from fraudulent activity by hedge fund advisers.

Impact of Regulatory Changes on Investment Advisory Firms

Legal, regulatory and compliance requirements for investment adviser firms have proliferated dramatically over the last several years. For example, regulations adopted by the Commission during the past few years now require a variety of written policies relating to privacy, proxy voting, codes of ethics, and an adviser's entire compliance program, in addition to the inspection staff's focus on other written policies including best execution, e-mail, and business continuity planning. In light of these developments, we urge the Division to examine the cumulative effect of the changes that have occurred in investment adviser regulation, including the benefits and costs of regulation.[26] In addition to covering the entire landscape of advisers and regulation, the review should include a focus on the costs of regulation on small investment advisory firms.[27] The IAA would welcome the opportunity to assist the Division in such a review. In addition to the initiatives discussed earlier, we suggest that the Commission sponsor an investment adviser roundtable to solicit input and provide an opportunity for dialogue about the cumulative effect of all the investment advisory rules and regulation on the industry.[28]

Andrew J. Donohue, "Remarks Before the 4th Annual Hedge Funds and Alternative Investments Conference," (May 23, 2007) (discussing rule proposals).

[25] *See* Letter from Karen L. Barr and Monique S. Botkin, Investment Adviser Association to Nancy Morris, Secretary (Mar. 9, 2007).

[26] *See, e.g.,* "The Cost of Regulation Study" commissioned by the UK's Financial Services Authority and completed by Deloitte in 2006, which addresses the costs financial services firms incur in complying with the Financial Services and Markets Act 2000. John Tiner, the FSA's chief executive, explained the background of the study saying, "We are determined to strike the right balance between discharging our statutory duties and avoiding unjustified costs. We can do this only with a sound understanding of both the benefits and the costs of regulatory action." *The Cost of Regulation Study,* Deloitte, p. 1 (June 28, 2006).

[27] As of April 6, 2007, there were 10,446 entities registered with the Commission as investment advisers. More than two thirds (68.2%) of these firms have 10 or fewer employees (5,110 reported having 1-5 employees and an additional 2,013 reported having 6-10 employees). *See Evolution/Revolution: A Profile of the Investment Advisory Profession* (expected July 2007), which will be available on the home page of our web site.

[28] The Commission's only roundtable on investment adviser regulatory issues was held in May 2000.

Conclusion

Thank you for the opportunity to present our views on these important issues affecting investment advisory firms. We are pleased to provide our suggestions regarding the Division's investment adviser regulatory review. Please do not hesitate to contact Monique S. Botkin, IAA Counsel, or the undersigned if you have any questions or if we may provide any additional information regarding these matters.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

cc: Mr. Robert E. Plaze, Associate Director, Division of Investment Management
Mr. Douglas J. Scheidt, Chief Counsel, Division of Investment Management

July 24, 2007

Via Electronic Filing

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5669
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, DC 20210

Attn: Fee Disclosure RFI

Ladies and Gentlemen:

The Investment Adviser Association[1] appreciates the opportunity to provide comments concerning the investment-related and plan administrative fee and expense information that should be provided to participants[2] in participant-directed individual account plans.[3] Our comments support meaningful disclosure of expense and other information relevant to participants' investment decisions under their plans.[4]

Background

The IAA strongly supports efforts to ensure that plan participants are provided meaningful information about the fees and costs associated with the investment options under their defined contribution plans. Such information is critical to retirement security because of the increasing percentage of participants that are covered by defined contribution, rather than defined benefit, retirement plans. Under defined contribution plans, the amount of the retirement benefits payable to a participant depends upon the level

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 500 firms that collectively manage in excess of $8 trillion for a wide variety of individual and institutional clients. For more information, please visit our website: www.investmentadviser.org.

[2] For ease of reference, the use of the term "participant" includes both participants and beneficiaries.

[3] Fee and Expense Disclosures to Participants in Individual Account Plans, 72 Fed. Reg. 20457 (2007) ("RFI").

[4] We also concur generally with the principles outlined in the Joint Submission to the Department of Labor: Recommendations for Participant-Level Disclosure of Defined Contribution Plan Fee Information submitted today by 12 trade associations.

1050 17th Street, N.W., Suite 725 · Washington, DC 20036-5503 · 202.293.4222 ph 202.293.4223 fx · www.investmentadviser.org

of contributions and the return on the underlying investments of his or her individual plan account. In many such plans, the participants, rather than the plan fiduciaries, determine the specific investments in which their accounts are invested.

Plan fiduciaries still play important roles in participant-directed plans, however, in that they are responsible for selecting the "menu" of options available to participants, as well as administering the plan. Under the fiduciary responsibility provisions of ERISA, plan fiduciaries must perform these duties in a prudent fashion, and solely in the interests of participants. In addition, plan fiduciaries retain the responsibility to administer the plan, and often engage various service providers to assist in such administration. For example, a third party recordkeeper may maintain participant accounts and process participant requests, such as investment changes and distributions. Plan fiduciaries may enter into a variety of arrangements to compensate these third parties.

In developing guidance in this area, the DOL should distinguish between the disclosures necessary for a participant to choose among a fixed set of investment options and the disclosures appropriate to plan fiduciary functions. Plan participants are not parties to the recordkeeping and other administrative arrangements established by the plan fiduciaries, and do not require detailed information concerning such agreements in order to direct the investment of their accounts. Similarly, their investment decisions are limited to choosing among those investment options that the fiduciaries have selected for the plan, and therefore do not require information concerning a broader universe of investments.

Disclosure of Information Relating to Plan Investment Options

Content

In response to the first set of questions posed by the RFI, we recommend that plan participants receive the following information concerning the investment options available under their plans:

1. The overall expense ratio applicable to the option;

2. The effects of such fees on a $10,000 investment in the option;

3. The option's historical investment performance;

4. Identification of the investment objective and risk/return characteristics of the option; and

5. "Benchmark" expense ratios and performance data for other investments with similar investment objectives and risk/return characteristics.

The first four categories would provide information specific to the particular investment, and the fifth category would provide context to the information in the first four categories by providing average expense ratios and performance for similar types of investments.[5]

The information detailed above should be accompanied by a short explanation that the consideration of fees should constitute only one component of the participant's decision-making process. In this respect, undue attention to fees to the exclusion of other factors might lead participants to invest their entire accounts in money-market and other stable value investments in order to incur the lowest fees. Such short-term investments generally are not considered suitable as the exclusive investments for participants saving for long-term retirement needs.

In addition to this expense information, plan participants should receive details concerning any charges that may be assessed directly against their accounts in connection with plan investment transactions. For example, any charges that might be triggered upon purchase or sale of a particular option (such as a commission, a contingent deferred sales charge, a surrender charge, or a market value adjustment) are relevant to a participant's assessment of the consequences of choosing a particular investment, and may affect his or her ultimate return.

Furthermore, this information (or its reasonable equivalent) should be available to participants with respect to all of the investment options available to them under the plan, in order that participants may compare directly the applicable fees.[6] Failure to do so might lead participants to believe mistakenly that certain investment options do not involve any expenses.

Delivery and Format

We believe that DOL regulations should require that the information described above be furnished to plan participants by plan fiduciaries. Such regulations, however, should allow plan fiduciaries to tailor the information in a manner that is responsive to the circumstances of their workforce, plan, and plan options. We also urge the DOL to allow and encourage the use of electronic media, such as e-mail, internet and intranet communications, including relevant links to providers' websites. Such an approach would serve to reduce the substantial preparation and printing costs inherent in new disclosure rules, while also providing the most up-to-date information concerning investment options.

Summary information would be preferable to lengthy descriptions in conveying these important disclosures to plan participants. In addition, although a completely uniform format may not be feasible for a given menu of investments, to the extent possible,

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[5] Information concerning the impact of fees and expenses on a specific individual participant's account would be difficult and costly to calculate. We therefore would not support requiring disclosure of participant-level information in this regard.

[6] We note, however, that this information would not be readily available in usable form with respect to options available under a brokerage window program allowing participants to invest in a wide number and variety of investments, such as individual stocks.

the information should be provided in a consistent format that facilitates comparisons among the options. The disclosure should avoid excessive detail, and yet provide key information to participants deciding among plan investments, in a format that is clean, simple, and presented in plain English. Such a format would be well-suited to the average plan participant and cost-effective for the plan.

Investment Education

The IAA supports investment education for participants in participant-directed plans, and commends the Department's work in developing the booklet entitled, "A Look at 401(k) Fees," in this regard. Although plan fiduciaries may determine to provide additional materials, such as glossaries of plan and investment terms, any DOL guidance in this area should allow and encourage flexibility by plan fiduciaries in determining the type and extent of investment education appropriate for the specific workforce, plan and plan options, as well as the plan participants' access to internet resources.

Disclosure of Information Relating to Plan and Individual Account Administrative Fees and Expenses

This portion of the RFI addresses administrative fees (at both the plan and individual account levels), as opposed to investment-related fees. To the extent such administrative fees are paid for by participants as a set individual charge (e.g., loan or QDRO fee) or as a pro rata or per capita share of aggregate plan costs, we believe that participants should have an understanding of the actual amounts charged to their individual account either through descriptions in the plan's Summary Plan Description or through separate disclosure documents. Pro rata or per capita charges should be disclosed upon enrollment and annually thereafter, while set individual charges should be disclosed at the time that the participant initiates the transaction that triggers the charge, such as a QDRO, loan or similar request. In addition, the assessment of any such fees against an individual account should be reflected in the participant's quarterly account statement.

On the other hand, we do not believe that the actual aggregate amounts paid for plan administrative expenses (i.e., audit fees, legal fees, trustee fees, etc.) would be helpful to plan participants in that these fees are determined under arrangements negotiated between the plan fiduciaries and service providers. Given that the participants play no role in establishing audit, legal, trustee, or recordkeeping arrangements, and, therefore, have no context in which to assess their reasonableness, disclosure of the financial details of such arrangements would not be helpful or relevant to the average participant. Of course, to the extent that a participant wished to access such information, he or she could consult the plan's Form 5500 for plan-level expense details.

Distinctions Between Participants in 404(c) Plans and Participants in Non-404(c) Plans

The RFI also requests comment concerning the distinctions (if any) between the informational needs of participants in 404(c) plans and participants in non-404(c) plans.

We note that plan fiduciaries of non-404(c) plans retain fiduciary responsibility under ERISA for participants' investment choices. The participants' need for information (and the consequences of not obtaining such information) might not be considered as critical under such circumstances. On the other hand, as a matter of public policy, equivalent disclosure under both 404(c) and non-404(c) plans may be preferable in order to encourage appropriate investment choices in all participant-directed plans.

In light of these factors, the IAA recommends that any DOL rules on investment disclosures to participants responsible for directing their plan investments not distinguish between 404(c) and non-404(c) plan participants.

Conclusion

We truly appreciate the opportunity to provide our views on these important issues. Please do not hesitate to contact me if you have any questions or would like any additional information.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

INVESTMENT ADVISER
ASSOCIATION

August 10, 2007

Via Electronic Mail

Mr. Robert E. Plaze, Associate Director
Ms. Jennifer Sawin, Senior Special Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Comprehensive Review of Investment Adviser Recordkeeping Rules

Dear Mr. Plaze and Ms. Sawin:

In several recent speeches at industry conferences and meetings, SEC staff have indicated that the Division is undertaking a "comprehensive review and wholesale rethinking" of the recordkeeping requirements for investment advisers.[1] The Investment Adviser Association[2] commends the staff for addressing these important issues. We agree that the recordkeeping requirements, as set forth primarily in Rule 204-2 under the Investment Advisers Act of 1940, are in need of modernization to provide clarification, to eliminate outdated references, and to better reflect current business practices and technologies.

This letter is intended to assist in the staff's review of the recordkeeping requirements by highlighting some of the IAA's concerns regarding potential revisions to the rules. We welcome the opportunity to continue our discussions regarding these issues in greater detail with you and your colleagues.

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[1] *See, e.g.,* Andrew J. Donohue, "Remarks Before the IA Week and the Investment Adviser Association 9th Annual IA Compliance Best Practices Summit 2007," (Mar. 22, 2007), available at http://www.sec.gov/news/speech/2007/spch032207ajd.htm ("The Division is currently undertaking a comprehensive review and wholesale re-thinking of the advisers' recordkeeping requirements.") *See also,* Andrew J. Donohue, "Keynote Address at 2007 Mutual Funds and Investment Management Conference," (Mar. 26, 2007), available at http://www.sec.gov/news/speech/2007/spch032607ajd.htm.

[2] The IAA is a not-for-profit association in Washington, DC that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of institutional and individual clients. For more information about the IAA, please visit our web site: www.investmentadviser.org.

The IAA understands that the staff is considering various options with respect to rule revisions, ranging from retaining the current framework of Rule 204-2 to completely revising the rule. We also understand, based on conversations with staff and statements made by staff at industry conferences and meetings, that the SEC staff is seriously considering requiring investment advisers to follow the "business as such" standard for recordkeeping currently applicable to communications sent or received by broker-dealers, as set forth in Rule 17a-4(b)(4) under the Securities Exchange Act. This rule requires a broker-dealer to maintain "all communications received and copies of all communications sent by such member, broker, or dealer (including inter-office memoranda and communications) relating to [its] business as such."

Some industry observers have posited that harmonization of the broker-dealer and investment adviser recordkeeping rules is desirable, that a "business as such" standard would provide clear guidance with respect to the recordkeeping requirements, and/or that a "business as such" recordkeeping standard would be an easy standard for investment advisers to apply. Based on the reasons set forth below, we do not agree.

1. Harmonization Of The Broker-Dealer And Investment Adviser Recordkeeping Requirements Is Neither Necessary Nor Desirable

Although harmonization with the broker-dealer recordkeeping requirements has conceptual appeal, it would affect only a small number of investment advisers, while burdening the rest. Of the 10,446 investment advisers registered with the SEC as of April 6, 2007, only a small percentage (6%) are dually registered as broker-dealers and only a slightly larger percentage (9%) are registered representatives of a broker-dealer or have employees who are registered representatives of a broker-dealer.[3] Accordingly, the overwhelming majority of registered investment advisers are neither dually registered nor registered representatives of a broker-dealer.

In addition, most investment advisers (75%) are not affiliated with broker-dealers. Further, we understand that many of the 25% of investment advisers that are affiliated with broker-dealers are operated as separate businesses with completely separate broker-dealer and investment adviser operations and likely have little or no overlap in recordkeeping practices. Also, the percentage of investment adviser firms affiliated with broker-dealers has been steadily declining over the course of the past three years: investment adviser firms affiliated with broker-dealers declined by 3% last year and 2% in each of the prior two years.

Given that the vast majority of registered investment advisers are not dually registered and a decreasing percentage of investment advisers are affiliated with broker-

[3] Statistical information has been compiled from IARD data gathered in conjunction with the 2007 *Evolution/Revolution* report published by the IAA and National Regulatory Services. The report is available on our web site: www.investmentadviser.org.

dealers,[4] there is no need to harmonize the recordkeeping requirements with respect to communications because most investment advisers operate independently from broker-dealers. Harmonization of the recordkeeping rules would create no efficiencies for most investment advisers and broker-dealers and would provide no added benefit to investors. In addition, investment advisers that are dual registrants have not sought harmonization of the rules. Any dual registrants that prefer harmonization of the broker-dealer and investment adviser recordkeeping rules, however, can keep additional records voluntarily.

From a regulatory policy standpoint, the inherent differences between the business of investment advisers and broker-dealers support different recordkeeping regimes. Harmonization for its own sake simply does not make sense. Broker-dealers interact with customers in a sales process intended to result in a securities transaction. They have custody of client assets, execute trades, and typically are more retail focused than investment advisers. Broker-dealers have a high degree of interconnectivity with market centers, underwriters and other entities and may have one or more branch offices, which call for more internal communications and supervision.

2. <u>"Business As Such" Would Not Provide Clear And Precise Guidance To Investment Advisers</u>

The IAA fully supports staff efforts to modernize Rule 204-2 to provide clarification, to eliminate outdated references, and to reflect current business practices and technologies. Notwithstanding the dramatic technological changes that have taken place over the past decade, however, we think that the current framework of the rule - which sets forth requirements regarding the retention of broad categories of records - provides a useful clarity and certainty with respect to the required retention of documents that has served all constituencies well. On the other hand, the "business as such" framework, if broadly applied without specifically excluded categories of documents, would not provide the same clear guidance for investment advisers, leading to uncertainty in its application.

Indeed, the "business as such" standard has not brought clarity to the broker-dealer universe. This uncertainty is reflected in several letters that the Securities Industry and Financial Markets Association has sent to the SEC staff over the course of the past few years seeking clarification of the "business as such" recordkeeping standard, particularly as it pertains to e-mail. For example, a February 4, 2005 SIA letter stated:

> While most of the SEC's books and records rules identify specific documents that must be kept, the standard for the Business as Such rule is vague and subject to varying interpretations, especially as it

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[4] We recognize that, as a result of the D.C. Circuit's decision vacating Rule 202(a)(11)-1 under the Investment Advisers Act of 1940 (*Financial Planning Ass'n v. S.E.C.*, 2007 WL 935733, C.A.D.C. (March 30, 2007)), some broker-dealers may elect to register as investment advisers in order to continue to offer fee-based accounts.

> relates to email communications. The applicable SEC rule (enacted in 1939 in the context of record keeping rules) states that communications are subject to retention if they relate to the firm's "business as such." This highly subjective standard does not lend itself to a hard and fast compliance solution since each communication would theoretically have to be reviewed to determine if it relates to the firm's "business as such" before being archived. Moreover, the lack of SEC guidance exposes firms to unnecessary regulatory risk since a broker-dealer's good faith attempt to define "business as such" in its retention policy could be found to be lacking by enforcement staff with a different interpretation.[5]

Although we recognize that a few subsections of the current recordkeeping rule incorporate a "business as such" standard, use of that term in those contexts is largely superfluous. Investment advisers are required to retain "all bills or statements (or copies thereof), paid or unpaid, relating to the *business* of the investment adviser *as such*;" "all trial balances, financial statements, and internal audit working papers relating to the *business* of *such* investment adviser;" and "all written agreements (or copies thereof) entered into by the investment adviser with any client or otherwise relating to the *business* of *such* investment adviser *as such*."[6] Given that bills, financial statements, and written agreements with clients are often critical to an adviser's operations, are easily identifiable, and are not typically voluminous documents, it is often more efficient for an adviser to maintain all such documents, rather than to determine, on a case-by-case basis, whether each such document pertains to the adviser's "business as such." Application of the same standard to a much broader and more ambiguous category of documents, on the other hand, would result in confusion, uncertainty, and the unnecessary retention of large volumes of documents.

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5 Available at http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/4656.pdf. See also, April 7, 2006 SIA letter ("The interpretation of 'business as such' under Rule 17a-4(b)(4) continues to be problematic for SIA members because of the lack of clear, explicit guidance from the SEC on its meaning")(pertaining primarily to e-mail communications) and ("Further, the related issue of what constitutes a 'communication' (particularly in the context of electronic applications) continues to be undefined and subject to a variety of interpretations. In an era of increasingly complex technology, SIA members are without concrete guidance on what constitutes a communication which is required to be saved.") Available at http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/15234.pdf .

6 Emphasis added. These recordkeeping requirements are set forth in Rule 204-2(a)(5), (6), and (10) of the Investment Advisers Act of 1940, respectively.

3. The "Business As Such" Recordkeeping Standard Would Lead Many Investment Advisers To Unnecessarily Retain Large Volumes Of Documents And Would Be Burdensome And Expensive

A "business as such" recordkeeping standard would likely lead many investment advisers to retain large volumes of documents, which would be extremely burdensome and would have a substantial negative business impact on most investment advisers. The majority of investment advisers that participated in a recent industry survey[7] indicated that they retain only records that are required to be maintained under the recordkeeping rules.[8] Only 38% of survey respondents keep *all* records generated by or received by their business. In addition, many of the advisers that maintain all records do so for office management purposes, which is significantly less burdensome than maintaining documents pursuant to a regulatory obligation.

Although the volume of records maintained under a "business as such" framework would be overwhelming for investment advisers, much of this volume would consist of irrelevant or immaterial information. In addition, given the volume of materials that would be maintained, and the length of time they would have to be maintained (most records must be kept for five to six years under the current rules), the "business as such" framework would be extremely difficult for investment advisers that do not maintain records electronically.[9] An expanded recordkeeping requirement would also increase costs significantly for investment advisers without any compelling policy justification and without meeting the stated goal of obtaining information in a "more meaningful and less obtrusive manner."[10]

7 About 450 compliance professionals participated in the 2007 Investment Management Compliance Testing Survey ("Compliance Testing Survey"), which was co-sponsored by ACA Compliance Group, IM Insight, Old Mutual Asset Management, and the IAA.

8 This response excludes e-mail, which was addressed separately in the survey.

9 It is very difficult, time-consuming, and costly for investment advisers to convert paper documents to electronic documents. Compliance professionals who participated in the Compliance Testing Survey cited the difficulty in converting paper documents to electronic documents as the biggest obstacle to maintaining more firm records in electronic format.

10 *See,* Andrew J. Donohue, "Keynote Address at the Practicing Law Institute Investment Management Institute 2007 (Apr. 12, 2007), available at http://www.sec.gov/news/speech/2007/spch041207ajd.htm ("As we go through our analysis, we will look at the purpose behind each requirement and determine whether we can obtain the same information in a more meaningful and less obtrusive manner.")

* * * * *

We appreciate the opportunity to provide our views on this important issue. Please do not hesitate to contact us if we may supply additional information or assistance to you regarding this matter.

Sincerely,

Valerie Baruch

Valerie Baruch
Assistant General Counsel

Cc: Andrew J. Donohue, Director
Division of Investment Management

September 20, 2007

Via U.S. and Electronic Mail

Douglas J. Scheidt
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Request for no-action relief relating to Rule 206(4)-2 under the Investment Advisers Act of 1940

Dear Mr. Scheidt:

The Investment Adviser Association[1] is writing to request no-action relief under Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-2 thereunder.[2] In particular, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action under Rule 206(4)-2 of the Advisers Act if a registered investment adviser forwards certain funds or securities it receives for its client to the client or the client's custodian in accordance with the procedures and conditions described below. In our view, the operation of these procedures will ensure that the provisions and policy goals of Rule 206(4)-2 will be met and that the interests of clients relating to the appropriate deposit of such funds and securities will be better protected.[3]

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[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a non-profit organization that represents the interests of the investment advisory profession. Founded in 1937, the IAA's current membership consists of nearly 500 SEC-registered investment advisory firms that collectively manage in excess of $8 trillion for a wide variety of individual and institutional clients. More information regarding the IAA, including a list of member firms, is available on our web site: www.investmentadviser.org.

[2] *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2176 (Sept. 25, 2003) (Adopting Release); *Custody of Funds or Securities of Clients by Investment Advisers,* Advisers Act Release No. 2044 (July 18, 2002) (Proposing Release).

[3] This request for no-action relief is without prejudice to potential additional requests for relief regarding other aspects of the custody rule, certain of which we have previously discussed with Division staff.

Applicable Law

Section 206(4) of the Advisers Act generally makes it unlawful for an investment adviser to engage in any act, practice or course of business that is fraudulent, deceptive or manipulative. Rule 206(4)-2 under the Advisers Act generally makes it a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for a registered investment adviser to have custody of client funds or securities unless a "qualified custodian" maintains the funds or securities in a separate account for each client under that client's name or in accounts that contain only the client's funds and securities under the investment adviser's name as agent for the client.

The Commission initially adopted Rule 206(4)-2 in 1962 to require "an investment adviser who has custody of funds or securities of any client to maintain them in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency, of the investment adviser."[4] Rule 206(4)-2, in its current form, is a result of amendments proposed in 2002 and adopted in 2003 to "reflect modern custodial practices and clarify circumstances under which an investment adviser has custody of client assets."[5] The amended rule defines "custody" as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them,"[6] and includes three examples designed to illustrate circumstances under which an investment adviser has custody of client funds or securities, of which only the following is relevant for purposes of this no-action request:

> Possession of client funds or securities, (but not of checks drawn by clients and made payable to third parties), unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them.[7]

The release adopting the amendments noted that this example clarifies that an adviser has custody when it has possession of client funds or securities, even briefly, as those assets may be at risk of misuse or loss. The Commission, however, explicitly excluded from the definition of "custody" instances when an adviser inadvertently received a client's funds or securities and returns them to the sender promptly.[8]

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[4] *Adoption of Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 123 (Feb. 27, 1962).

[5] Adopting Release, *supra* note 2.

[6] Rule 206(4)-2(c)(1).

[7] Rule 206(4)-2(c)(1)(i).

[8] This exclusion appears to have been based generally on a staff position under which a registered investment adviser is deemed not to have custody or possession of client funds or securities as a result of procedures developed by the adviser intended to ensure that the adviser's clients did not deliver funds or securities to the adviser and, if a client did deliver funds or securities to the adviser, to require the adviser to

Shortly after the Commission amended Rule 206(4)-2, the Commission staff provided informal commentary about the Rule in its Staff Responses to Questions about Amended Custody Rule ("Staff Q&A").[9] Of particular relevance, Question II.l of the Staff Q&A states:

Q: If an adviser inadvertently receives securities from a client, under the amended rule may the adviser forward the securities to the qualified custodian instead of returning the securities to the client?

A: No. If the adviser does not return the securities to the sender within three business days, the adviser not only has custody but has also violated the amended rule's requirement that client securities be maintained in an account with a qualified custodian.[10]

Although this Staff Q&A refers only to securities, the language of Rule 206(4)-2 and other staff interpretations may suggest that an investment adviser could, when it receives client settlement checks, tax refund checks or other assets, be deemed to have custody of these assets.[11] As a result, an adviser could be out of compliance with the Rule if the adviser receives client assets and forwards those assets to a client or its custodian. An adviser's only available remedy under the Rule would be to return the funds or securities to the sender within three business days.

Facts

Our member firms have identified the following situations where they may receive clients' securities or funds inadvertently and it would be in clients' best interests to forward the securities or funds to the client or custodian rather than return them to sender:

1. *Settlement checks from class action lawsuits*. Advisers may receive checks from commercial class action administrators distributing funds in settlement of class

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return immediately the funds or securities to the client. Proposing Release, *supra* note 2, at n. 18 (citing *Hayes Financial Services*, SEC No-Action Letter, (Apr. 2, 1991)).

[9] Staff Responses to Questions about Amended Custody Rule, available at http://www.sec.gov/divisions/investment/custody_faq.htm (updated as of Jan. 10, 2005).

[10] *Id*.

[11] Indeed, temporary possession of a check made out to the client or a former client arguably is not "possession" of "funds" in that the check is not negotiated to the adviser and is not available for the adviser to cash or deposit. The adviser can only pass it along to a person or entity with authority to negotiate the instrument – the client or its custodian. Similarly, the money represented by the check would not be "funds available" to the adviser in case of insolvency, a stated concern of the custody rule.

action lawsuits.[12] These lawsuits are brought by others in situations where neither the client nor adviser initiates the class action legal proceedings. In fact, clients are required to waive their own rights to bring suit in order to receive payments under most of these settlements. Typically, the amounts of such checks are relatively small.

2. *Fair Funds.* By way of example, late last year, a number of investment adviser firms began receiving checks referencing the SEC Specialist Settlement Fund without having submitted proofs of claim or other documentation related to the Fund. The checks were delivered in connection with the Commission's 2004 action charging seven NYSE specialist firms with certain trading violations. As part of the settlement, the firms made payments to a fund that, in turn, was to be distributed to "injured customers" harmed by the trading violations. A fund administrator was appointed to identify injured clients and issue reimbursement checks. It is unclear how the fund administrator identified investment adviser firms to whom it issued checks, but many of the checks were made payable to the adviser with a custodial master account indicated on the check. Since then, this situation has occurred in a number of additional Fair Fund actions.

3. *Tax refund checks from the IRS, state or other governmental taxing authorities*. Advisers sometimes receive tax refund checks because they may have sent or forwarded required tax payments at the direction of their clients or the clients' agents such as tax lawyers, accountants, or others. They may have also completed tax forms and filed them with a taxing authority. Under the Rule, an adviser must return the check to the taxing authority rather than forwarding the check to the client or the client's custodian.

4. *Dividend payments and stock certificates*. Sometimes advisers receive stock certificates or dividend checks in the name of their clients. On occasion, an adviser may receive stock certificates (or evidence of new debt) in a class action involving bankruptcy where shares are issued in a newly organized entity, or as a result of a business reorganization.

Most of the checks received by advisers in these contexts are made out to the client or the client's account. Checks payable to the client's account may also include the adviser's name as agent for the client.[13] Less frequently, checks are made payable to the

[12] This situation of inadvertent receipt often arises because class action administrators have the adviser's name and address where the adviser has assisted in filing proofs of claim on behalf of clients. Further, proofs of claim and related forms often have room for only one address and telephone number or request the name of a person to be contacted for further information. This role is frequently filled by the adviser.

[13] Checks may be construed as payable to the client if the client is identified in "any way, including by name, identifying number, office, or account number." Uniform Commercial Code Article 3 – Negotiable Instruments, Section 3-110. Similarly, checks payable to a person identified as agent for another would be payable to the represented person. *Id.*

adviser without reference to a client or client account on the check itself but are for the benefit of an identifiable client.[14]

In each of these situations, the investment adviser has not directly or indirectly caused the third party to deliver client assets to it and has no control over whether it receives client assets because the third party payor or sender is not connected to the adviser-client relationship. The involvement of the adviser as the client's fiduciary may create uncertainty on the part of the third party as to the correct destination of funds or securities. However, because the third party is not a part of the advisory relationship, the adviser cannot compel the third party to send assets directly to the correct destination. In addition, advisers have, in good faith, used their reasonable best efforts to cause third parties to deliver client assets to their clients or clients' custodians. Despite such efforts, some third parties continue to deliver client assets to the advisers without regard to the advisers' instructions to address and send such client assets to the relevant client or a qualified custodian. For example, advisers have requested third parties such as Fair Fund administrators to send distribution checks directly to clients or their custodians. The administrators nevertheless continue to send the distributions to advisers without regard to these requests. Thus, an adviser controls only its own procedures to safeguard client assets, as discussed below. We believe that in the situations and under the circumstances described above, an investment adviser inadvertently receives client assets.

Scope of Relief Requested

In the circumstances described above, returning funds or securities to the sender may work to the detriment of clients' interests, for example, by creating additional and unnecessary delays or even risking loss of such funds or securities.[15] Nor does returning funds or securities to the sender make sense from a cost-benefit perspective. In general, the amounts involved are very small. Thus, the administrative costs of returning these inadvertent items to the sender would impose significantly more effort and related transactional and tracking costs than many or most of the transactions are worth in the first place. To address these issues, we seek no-action relief under the following circumstances:

1. The adviser inadvertently receives client securities or funds from a third party.
2. The adviser forwards the client securities or funds to the client or the client's custodian promptly, but in no event later than five business days following receipt by the adviser of the client assets.

[14] The adviser would be able to ascertain that the check is for the benefit of a client rather than the adviser based on a cover letter, accompanying documents, or other surrounding circumstances.

[15] To illustrate the difficulty and potentially large magnitude of resolving misdirected items, see the SEC's enforcement matter *In Re Bank of New York*, SEC Rel. No. 53709, File No. 3-12269 (Apr. 24, 2006), available at http://www.sec.gov/litigation/admin/2006/34-53709.pdf. That case involved declaring "lost" client funds and securities sent to the client whose correspondence was returned as undeliverable, resulting, in part, in $11.5 million escheating to the State of New York from 1998 to 2004 affecting over 14,000 individuals.

3. The adviser performs the function of forwarding the securities or funds without imposing any additional service charges other than the fees charged for managing the clients' funds under the client advisory agreement.
4. The adviser provides written disclosure to its client of the practice of forwarding such securities or funds in the advisory agreement, or in notice given or mailed to the client, or in the adviser's Form ADV Part II disclosure.
5. The adviser establishes and implements policies and procedures reasonably designed to protect client funds and securities from loss and to track receipt and transmittal of these assets, including procedures reasonably designed to ensure that the adviser: (1) promptly identifies client assets that it inadvertently receives; (2) promptly identifies the client (or former client) to whom such client assets are attributable; (3) promptly forwards client assets to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; (4) promptly returns to the appropriate third party sender any inadvertently received client assets that the adviser does not forward to its client (or former client) or qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; and (5) maintains and preserves appropriate records of all client assets inadvertently received by it, including a written explanation of whether (and, if so, when) the client assets were forwarded to its client (or former client) or a qualified custodian, or returned to the third party sender.

Analysis

Safeguards Provided by Proposed Conditions

The conditions and procedures discussed above would significantly mitigate the risks and concerns that the custody rule is intended to address. These procedures are designed to minimize receipt of such assets where feasible, require advisers to monitor and document the receipt of any checks or securities, to deliver any check to the custodian or client promptly,[16] and to provide full notice to clients regarding the firm's practice of forwarding funds and securities. Indeed, the procedures provide more protection against misappropriation than the return-to-sender policy adopted by the Commission.

These procedures would also ensure that an adviser upholds its fiduciary duty to safeguard its clients' assets. Question II.1 of the Staff Q&A addresses an adviser's receipt of securities sent by the client. This Q&A, however, does not appear to contemplate the situation of client assets that are sent to an adviser by someone other than the client. In this context, the staff's guidance would require an adviser to return client assets not to its client or the custodian, but to the sender – an unrelated party – who would not be in a position to safeguard the assets and could lose or misuse the assets. Unlike advisers, these third parties are unlikely to be fiduciaries of the clients. If an

[16] This direct delivery to clients is consistent with the result of the *Hayes* no-action letter, *supra* note 8.

adviser were to follow the staff's interpretation and return settlement and refund checks and other client assets to a claims administrator or taxing authority, the adviser may be deemed not to be acting in the best interest of its clients, as such entities do not necessarily have procedures in place to ensure that client assets are properly safeguarded. These entities are not necessarily responsive to requests from investment advisers, nor are they subject to Commission examination. As a result, the adviser would have no assurance that the claims administrator or taxing authority would properly forward client assets to those clients or their custodians, as neither the claims administration nor the taxing authority may have the clients' or custodians' addresses and contact information as part of its official records. Thus, returning such securities or funds to the sender may work to the detriment of clients and create more problems than it solves.[17] Under the proposed procedures for handling settlement and refund checks and other assets, however, an adviser would take the safer course of forwarding these assets directly to its client or its client's custodian.

Comparison to Checks Drawn by a Client

The Commission, in adopting the recent amendments to Rule 206(4)-2, stated that "an adviser's possession of a check drawn by the client and made payable to a third party is not in possession of client funds for purposes of the custody definition."[18] The Commission also stated that an investment adviser may receive checks payable to the adviser for advisory or similar fees, but an adviser that "holds a check drawn by the client and made payable to the adviser with instructions to pass the funds through to a custodian or third party" would be deemed to have custody of client funds.[19] It would appear that Rule 206(4)-2 permits an investment adviser to receive a check drawn by a client and made payable to third party without being deemed to have "possession" or "custody" of client funds for two reasons: (1) the client would have knowledge that the check is in the adviser's possession, presumably because the client had written the check and forwarded it to the adviser; and (2) the client is protected from potential misappropriation by the adviser because the check is made payable to a third party and is subject to additional banking regulation protection.[20]

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[17] This situation is distinguishable from that in which the *client* sends its own assets to the adviser. In that case, requiring the adviser to return the assets to the client would deter clients from sending their assets to their advisers, with little risk of loss or delay of funds. *See Hayes, supra* note 8. On the other hand, requiring advisers to return client assets to a third-party sender would not deter such third parties from sending client assets to advisers in the future and would expose clients to increased risk of loss.

[18] Adopting Release, *supra* note 2.

[19] *Id*.

[20] Under the Uniform Commercial Code (UCC or state law), section 3-403, a person such as an adviser holding a negotiable instrument (*e.g.* a check made out to someone else or that person's account) would not be a *holder in due course* because the instrument would not have been negotiated to the adviser and the adviser would have no means to endorse, cash, or otherwise transfer the check. Any endorsement or attempted endorsement by the adviser to itself would be an "unauthorized signature." *See supra* note 13.

We believe this reasoning should apply to permit the adviser to forward client securities or funds from third parties to the client or the client's custodial account under the conditions discussed above. Many of the same protective factors that are present when an investment adviser receives a check from its client made payable to a third party would apply to a check from a third party, such as a settlement or refund check. Like a check written by the client to a third party, a check written by a third party to the client provides an adviser no means to endorse, cash, or otherwise transfer the check to itself. The client is protected against misappropriation by the adviser because the check is made payable to the client/client's account or endorsed to the client's account and is subject to banking protocols designed to identify and detect forgery. Finally, the client will have knowledge of the adviser's practices in this regard because advisers would disclose in writing the circumstances under which it may forward funds or securities to the client or custodian.

Conclusion

Accordingly, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action under Rule 206(4)-2 of the Advisers Act if a registered investment adviser forwards certain funds or securities it receives for its client to the client or the client's custodian in accordance with the procedures and conditions described above.

We appreciate your consideration of this request and look forward to further discussion with you. Please do not hesitate to contact us if we may provide any additional information or assistance in this regard.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

cc: Andrew Donohue, Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management

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Similarly, the broker-dealer regulatory structure has extensive safeguards and procedures for assuring proper identity and handling of securities.

October 4, 2007

<u>Via Electronic Mail</u>

Bradford P. Campbell
Assistant Secretary
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Dear Assistant Secretary Campbell:

We greatly appreciate your meeting with the Securities Industry and Financial Markets Association (SIFMA) and the Investment Adviser Association (IAA)[1] on July 12 to discuss the possibility of the Department issuing guidance under Section 406(b)(3) of ERISA. As we discussed, the LM-10 reporting changes, regional examination initiatives, and other developments have heightened the level of interest by members of our organizations to receive guidance from the Department on providing ordinary business-related meals, gifts, entertainment and conferences and the meals, travel, and accommodations associated with those conferences. We write to outline an approach to such guidance for your consideration, as well as to follow up on certain issues raised during the meeting.

Background and Need for Guidance

As you know, the provision of meals and entertainment to clients and prospective clients is a common, long-standing and entirely appropriate practice in the business community. In addition, it is a well-accepted practice in the benefit plan community for service providers to host educational conferences and meetings that are accompanied by reasonable meals, accommodations, travel arrangements, and entertainment. These

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[1] SIFMA, established in 2006 through the merger of the Securities Industry Association and The Bond Market Association, brings together the shared interests of more than 650 securities firms, banks and asset managers. More information about SIFMA is available on its home page: www.sifma.org.

The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

meetings and conferences serve important functions in the benefits community and provide valuable benefits to plans. First, they allow plan fiduciaries to meet personally with their financial services providers and thereby better monitor and discuss their investments and service agreements. Second, they benefit plan participants and beneficiaries by providing client plan fiduciaries with significant educational opportunities, including access to market experts and expanding clients' knowledge base about investment structures, the economy, and core concepts such as asset allocation, diversification and risk hedging. Third, they enhance opportunities for clients to build relationships with their investment managers, other providers, and other industry participants, which assists in the oversight of the plan's service providers and provides important information about industry best practices. Fourth, they provide clients with a better understanding of market conditions and trends in the industry, including the impact such trends may have on their portfolios, without a financial cost to their plans. Finally, they provide broad and continuing education regarding fiduciary obligations and duties, changes in the law and regulations, current initiatives, and other issues of legal significance.

Since ERISA was enacted, investment managers, broker-dealers and other financial services providers have operated under the understanding that reasonable and routine business-related expenses are permissible under ERISA. They understand that giving lavish or extravagant gratuities, including lavish business entertainment, travel unrelated to plan business, and gifts that operate as a *quid pro quo* or kickback, is prohibited by ERISA, securities laws, and criminal statutes. In light of this understanding, financial services providers generally have implemented policies and procedures reasonably designed to ensure that any expenses for meals, entertainment and gifts are reasonable, legitimately business-related, and are not offered as a bribe or improper payment.

Recently, however, issues have been raised regarding the Department's position with respect to the provision of reasonable meals and other entertainment to plan fiduciaries, including in the LM-10 context. Although the Department has never issued guidance in this area, some regional enforcement offices have indicated both to plan trustees and service providers that the Employee Benefits Security Administration will take a "zero tolerance" approach to routine business-related entertainment. This expression of a "zero-tolerance" approach has created uncertainty in the financial services community regarding whether *any* meals, entertainment, or other expenses are permissible, and if so, to what extent. This uncertainty impedes the ability of firms to establish and implement appropriate compliance controls, policies, and procedures regarding the provision of meals, entertainment, and conferences to plan fiduciaries. It is obviously difficult to create policies and procedures governing an activity that may not be permitted at all. Further, the lack of guidance in this area creates an unlevel playing field, which could be seen as disadvantaging firms that take a more conservative approach to such matters. It also may create an unlevel playing field with respect to positions taken by different regional offices of EBSA.

Accordingly, members of the investment management and broker-dealer communities would appreciate prospective written guidance from the Department.

Consistent with our earlier discussions, we outline a potential approach to such guidance below.

Approach to Guidance

We respectfully request that the Department confirm that it will not take enforcement action with respect to either (1) the provision of reasonable meals, entertainment, and conferences (including accompanying meals, travel and accommodations) to plan fiduciaries if the expenses constitute items that are fully disclosed to an appropriate plan fiduciary, and if those expenses could have been paid for by the plan under section 408(c)(2) of ERISA; ***or*** (2) the provision of entertainment, tokens, or gifts that, taken as a whole, are not such that they are intended to cause or would be reasonably judged to have the likely effect of causing a plan fiduciary to act in a manner that is not solely in the best interests of the plan. We understand that the "reasonableness" aspect of this principle-based approach may leave a gray area in which a facts-and-circumstances analysis must be conducted to determine whether the entertainment has improperly influenced a fiduciary. But, as you know, plan fiduciaries are accustomed to making these judgments under section 408(b)(2) and section 408(c)(2) of ERISA and there is no reason to assume that they will not exercise prudence in making these judgments in this area as well. Further, this approach is preferable to a detailed FAQ that attempts to cover every scenario that potentially could be presented.

The guidance we request is similar to other guidelines that that our members follow relating to gifts and entertainment. For example, NASD Conduct Rule 3060 as interpreted by the Financial Industry Regulatory Authority[2] permits ordinary and usual business entertainment "so long as it is neither so frequent nor so extensive as to raise any question of propriety."[3] Rule 3060 provides that no member may provide a gift that is valued at more than $100.[4] FINRA rules also require firms to have recordkeeping and supervisory systems in place to implement these guidelines.

A pending FINRA proposal to amend Rule 3060 specifically would require written policies and procedures reasonably designed to prevent the provision of business entertainment intended to cause or that would reasonably be judged to have the effect of

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[2] FINRA guidance under Rule 3060 is available on the FINRA website at: http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000596. FINRA was created in July 2007 through the consolidation of NASD and certain operations of the New York Stock Exchange. Firms that were members of NASD only at the time of the consolidation continue to be governed by NASD rules until a consolidated rulebook is created. FINRA has stated that it will continue to apply the same interpretive materials that applied previous to the consolidation.

[3] Letter to Henry H. Hopkins and Sarah McCafferty, T. Rowe Price Investment Services, Inc. from R. Clark Hooper, NASD (June 10, 1999). This guidance is available on FINRA's web site at: http://www.nasd.com/RulesRegulation/PublicationsGuidance/InterpretiveLetters/ConductRules/NASDW_002715.

[4] FINRA distinguishes between "gifts" and "entertainment." Gifts are items provided to others, including tickets to events *if the recipient is not accompanied by an employee of the firm providing the tickets.* If an employee of the firm accompanies the client, the item is considered "entertainment," not a gift. Similarly meals, receptions, and conferences at which firm personnel are present are considered entertainment.

causing a recipient to act inconsistently with the best interests of the client.[5] Similarly, Investment Advisers Act Rule 206(4)-7 requires investment advisers to establish and implement written policies and procedures reasonably designed by prevent violations of the Act. Consistent with these rules, any guidance provided by the Department should also be crafted to have the effect of enhancing compliance efforts by requiring firms to have written policies and procedures in place to ensure that payments are not intended to improperly influence fiduciaries.

During our meeting, Department staff queried whether a *de minimis* dollar threshold similar to that used in LM-10 guidance would be preferable to a more general "reasonableness" standard. While a dollar amount has the conceptual appeal of specificity, it also has a number of drawbacks that the reasonableness approach avoids. First, a reasonableness analysis along the lines we propose would be consistent with other regulatory standards and therefore would enable service providers to establish and implement one uniform set of policies and procedures that applies to all of their clients, whether covered by ERISA or not. Second, this approach provides flexibility for the Department to take enforcement action whenever the facts and circumstances, taken as a whole, indicate improper influence. Third, a reasonableness approach recognizes geographical disparities in costs in a way that a specific dollar limit does not.[6] Fourth, the reasonableness standard can apply separately to items such as meals and conferences that the plan could have paid for and to the token gifts that may not fall under section 408(c)(2) but would certainly be covered by any prudent person's idea of reasonable tokens – such as a logoed pen, baseball cap, or bookbag. In our view, a "reasonableness" standard provides appropriate flexibility while preserving the purpose of ERISA to deter abusive kickbacks or quid pro quo practices.

Bases for Guidance

Section 406(b)(3) of ERISA prohibits a fiduciary from receiving "any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan." This section of ERISA is intended to prohibit "under the table" illicit kickbacks or quid pro quos. Thus, fully disclosed expenses that would be reimbursable by a plan (*e.g.,* reasonable travel, food and other expenses associated with meetings or conferences to learn about and/or assist in monitoring an investment provider or strategy) should be reimbursable by a third-party provider. These expenses are not for the fiduciary's "own personal account" and generally do not arise "in connection with" a particular transaction. Rather, these types of expenses are permitted to be paid by the plan precisely because they reflect reasonable expenses incurred on behalf of the plan's participants, not on behalf of the fiduciary's personal account. In previous guidance related to section 406(b)(3), the Department has

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[5] *See Self-Regulatory Organizations, National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Interpretive Material to NASD Rule 3060 to Require Members to Adopt Policies and Procedures Addressing Business Entertainment*, SEC Rel. No. 34-55765 (May 15, 2007).

[6] *See id.* at p. 24 ("Given the significant variation in broker-dealer business models and size, and regional differences in what may be considered appropriate business entertainment, NASD concluded that a fixed-dollar standard or similar specific mandate would prove unworkable").

expressed the view that so long as a plan could compensate the service provider directly for such services, section 406(b)(3) did not preclude a third party from making payments to a plan fiduciary for what would otherwise be a valid plan expense.[7]

Similarly, under section 406(b)(3), reasonable and modest business entertainment should not be deemed to constitute a kickback because it is not likely to improperly influence the plan fiduciary's decision-making. During our meeting, a Department official expressed concern that the language of section 406(b)(3) may not provide room for this type of statutory interpretation. The Department itself, however, has recently acknowledged in the context of the LMRDA reporting requirements that "exceptions based on insubstantiality are commonly read into statutes that do not expressly contain them."[8] Indeed, practitioners have for years interpreted section 406(b)(3) in the context of its anti-kickback intent to prohibit only those payments that are explicit or implicit quid pro quos, in amounts or type that any prudent person would find excessive. A hallmark of this type of payment is the fact that it is given furtively, without the knowledge or acquiescence of a senior plan fiduciary. We believe that the legislative history of ERISA is consistent with this transparent, reasonable approach. To interpret the statute otherwise would effectively result in section 406(b)(3) prohibiting behavior that, by definition, can have no adverse effect on a plan or fiduciary and that, to the contrary, facilitates the many important and beneficial functions described above.

Conclusion

For all of these reasons, we respectfully submit that Department guidance is appropriate and request that the Department clarify that reasonable meals, gifts and entertainment may be provided to plan fiduciaries under ERISA, as well as payments of expenses that the plan could have lawfully paid. This guidance may take the form of a no-enforcement position, field assistance bulletin, or other Department opinion.

We would appreciate the opportunity to meet with you again to discuss our approach to guidance. We look forward to working with you on this important issue.

Sincerely,

Liz Varley   Karen L. Barr

Elizabeth Varley   Karen L. Barr

cc: Virginia Smith, Director, Office of Enforcement
Alan D. Lebowitz, Deputy Assistant Secretary for Program Operations
Robert Doyle, Director, Office of Regulations and Interpretations

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[7] For example, in the preamble to Prohibited Transaction Exemption 82-63 dealing with compensation arrangements, the Department stated: "In the Department's opinion . . ., section 406(b)(3) is not violated by reason of a fiduciary's receiving on behalf of the plan the gross loan fees from the borrower, in his capacity as a fiduciary to the plan, and then allocating . . . a portion of those fees previously fully disclosed and agreed to as the compensation for the fiduciary's services . . . . In that situation, the payments to the lending fiduciary are, in effect, made from the assets of the plan and should be accounted for as such."

[8] 72 Fed. Reg. 36106, 36115 (July 2, 2007).

October 5, 2007

Via Electronic Filing

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Revisions of Limited Offering Exemptions in Regulation D (Release No. 33-8828; IC-27922; File No. S7-18-07)

Dear Ms. Morris:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Commission's proposal to create a new exemption to the registration requirements of the Securities Act of 1933 for offers and sales to "large accredited investors" in proposed Rule 507 under Regulation D, among other Regulation D proposed amendments.[2] In connection with this Proposal, the Commission also requests additional comment on its December 2006 proposal to require investors in private investment funds formed under Section 3(c)(1) of the Investment Company Act of 1940 to be "accredited natural persons" under Regulation D ("Accredited Natural Person Proposal").[3] The IAA previously submitted comments to the Commission on the Accredited Natural Person

[1] The IAA (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *See Revisions of Limited Offering Exemptions in Regulation D*, SEC Rel. No. 33-8828; IC-27922 (Aug. 3, 2007) (Proposing Release or Proposal), available at http://www.sec.gov/rules/proposed/2007/33-8828.pdf, as published in 72 Fed. Reg. 45116 (Aug. 10, 2007).

[3] *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, SEC Release No. 33-8766; IA-2576; File No. S7-25-06 (Dec. 27, 2006), available at http://www.sec.gov/rules/proposed/2006/33-8766.pdf, as published in 72 Fed. Reg. 400 (Jan. 4, 2007). The SEC proposed to increase the eligibility amounts for natural person investors in hedge funds and private equity funds relying on Section 3(c)(1) of the Investment Company Act to require: (i) net worth of $1million or income of $200,000 individually (or $300,000 jointly with the spouse); and (ii) $2.5 million in investments (each as adjusted for inflation). Section 3(c)(1) funds are beneficially owned by 100 or fewer persons and do not make or propose to make a public offering of their securities.

Proposal, which we have attached again here for your convenience.[4] We incorporate that letter by reference and reemphasize certain of those comments.

The IAA commends the Commission and its staff for addressing important issues of investor eligibility for Regulation D offerings and for seeking comments on how this Proposal affects the Accredited Natural Person Proposal. While we generally support the Commission's reassessment of the financial eligibility standards for Regulation D offerings, we propose several modifications as discussed below. Specifically, we request the Commission to:

(1) Permit Section 3(c)(7) funds to utilize the limited advertising proposed in Rule 507;

(2) Harmonize the Accredited Natural Person Proposal for Section 3(c)(1) funds with the qualified client standard under the Investment Advisers Act of 1940;

(3) Harmonize the definition of "joint investments" in the two pending proposals with the definition of joint investments in Investment Company Act Rule 2a51-1;

(4) Retain the standard in Rule 501(a) of Regulation D for issuers to form a reasonable belief as to the qualification of investors; and

(5) Adopt a fiduciary adviser exemption to the Accredited Natural Person Proposal.

1. Section 3(c)(7) Funds Should Be Able to Utilize the Limited Advertising Proposed in Rule 507

The Commission proposes an exemption under new Rule 507 for offers and sales of securities to "large accredited investors." Individuals would be large accredited investors if they owned more than $2.5 million in investments (or joint investments) or have had individual annual income of more than $400,000 in the last two years (or $600,000 with one's spouse), each as adjusted for inflation.[5]

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[4] *See* Letter from Karen L. Barr, General Counsel and Monique S. Botkin, Counsel, Investment Adviser Association to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission (Mar. 9, 2007) ("March 9 Letter").

[5] The Commission selected the $2.5 million investments-owned standard for individuals and spouses based on the $2.5 million investments-owned standard it proposed in the Accredited Natural Person Proposal for certain Section 3(c)(1) funds. Entities would be required to have more than $10 million in investments (as adjusted for inflation) to qualify as large accredited investors. All purchasers would be required to be large accredited investors. Directors and officers of the issuer would be considered large accredited investors in addition to being considered accredited investors, without being subject to an income, assets, or investments requirement.

The exemption would permit limited written advertising (an "announcement") of these offerings, to include specified information outlined in the proposed Rule and optional information such as name, type, number, and price of securities being offered, and a brief description of the business of the issuer in 25 or fewer words. The Rule would permit an issuer to provide information in addition to the announcement if it reasonably believes the prospective purchaser is a large accredited investor. This information may be delivered to prospective purchasers through an electronic database that is restricted to large accredited investors. The Commission states in the Proposing Release that, "publication of such an announcement would not contravene the prohibition on general solicitation and advertising otherwise applicable to the offer and sale of securities in a Rule 507 transaction."[6]

In proposing the new Rule, the Commission relied on its exemptive authority under Section 28 of the Securities Act, rather than on Section 4(2) of the Securities Act. The Commission states in the Proposing Release that pooled investment vehicles formed under Section 3(c)(1) or Section 3(c)(7)[7] of the Investment Company Act would not be able to take advantage of the limited advertising proposed to be permitted under Rule 507. The Commission reasoned that because those funds are required to sell their securities in transactions not involving a public offering, and such vehicles typically rely on Section 4(2) through Rule 506, which expressly forbids general solicitation and general advertising, the funds would be precluded from selling their securities in reliance on new Rule 507.[8]

This position appears to be inconsistent with recommendations and conclusions made in the 2003 Commission Staff Report, *Implications on the Growth of Hedge Funds* ("Hedge Fund Report").[9] In the Hedge Fund Report, the staff recommended to the Commission that it eliminate the restrictions on general solicitation for private placement offerings of interests in Section 3(c)(7) funds. Specifically, the staff indicated that:

> [I]t may be worthwhile to consider the need for [general solicitation] limitations for funds whose owners are limited to investors that clearly meet a higher standard or may be presumed to be able to 'fend for themselves' such as, for example, the 'qualified purchaser' standard of Section 3(c)(7).[10]

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[6] Proposing Release at 20. The Commission notes that the proposal does not eliminate the prohibition on general solicitation and general advertising from the conditions of the exemption. *Id.* at 10.

[7] Section 3(c)(7) funds are offered to "qualified purchasers" and do not make or propose to make a public offering of their securities. Qualified purchasers include natural persons who own at least $5 million in investments.

[8] Proposing Release at 27.

[9] The Hedge Fund Report is available at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

[10] Hedge Fund Report at 87.

The staff further noted that:

> There seems to be little compelling policy justification for prohibiting general solicitation or general advertising in private placement offerings of Section 3(c)(7) funds that are only sold to qualified purchasers. . . . [P]ermitting funds, including hedge funds, that limit their investors to a higher standard (e.g., 'qualified purchasers') to engage in a general solicitation could facilitate capital formation without raising significant investor protection concerns.[11]

We agree with the staff's conclusion in the Hedge Fund Report that qualified purchasers in Section 3(c)(7) funds are financially sophisticated enough to fend for themselves in offerings, such that they should be eligible to participate in an offering with limited advertising permitted by proposed Rule 507. The Commission stated in the Proposing Release that it proposed higher dollar thresholds for large accredited investors due to increased investor risks relating to the limited advertising that would be allowed under Rule 507.[12] However, the $5 million investments threshold for natural person qualified purchasers in 3(c)(7) funds is twice the $2.5 million investment threshold proposed for large accredited investors. Thus, if large accredited investors would be considered sufficiently protected from any perceived risks associated with limited advertising under Rule 507 by virtue of their amount of investments, qualified purchasers would be sufficiently protected as well.

Accordingly, we believe the Commission should adopt the broader staff recommendations on general solicitation and general advertising articulated in the Hedge Fund Report. At a minimum, we urge the Commission under appropriate authority to permit 3(c)(7) funds to use the type of limited advertising that would be available to other issuers under proposed Rule 507.

2. The Accredited Natural Person Proposal Should Be Harmonized with the Qualified Client Standard

The Commission seeks comments on whether it should revise the Accredited Natural Person Proposal to include alternative income and investment standards similar to those used in the definition of "large accredited investor" in proposed Rule 507, or otherwise change the proposed accredited natural person standard. As we stated in our March 9 Letter, we believe the Commission should harmonize the accredited natural person standard with that of the $1.5 million net worth requirement applicable to

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[11] Hedge Fund Report at 100-101.

[12] Proposing Release at 14.

"qualified clients" of an adviser that charges performance fees under Advisers Act Rule 205-3.[13]

This approach would have the benefit of avoiding the creation of yet another standard for eligibility in the securities laws – *i.e.*, adding "accredited natural person" to "accredited investor" under the Securities Act, "qualified client" under Advisers Act Rule 203-5, "qualified purchaser" under Investment Company Act Section 3(c)(7), "qualified institutional buyer" under Securities Act Rule 144A, and "qualified eligible persons" under CFTC Rule 4.7. The application of these differing standards is burdensome, complicated, and confusing. In addition, adopting different standards would result in inequitable treatment of private investment funds compared with other private offerings. This different treatment does not appear to be supported by evidence of risk or benefit differentials among various types of private investments.

3. The Definition of "Joint Investments" Should Be Harmonized with Rule 2a51-1 Used for Section 3(c)(7) Funds

The Proposing Release notes that several determinations must be made to calculate "joint investments" to determine whether a natural person is an accredited investor or a large accredited investor. If both spouses sign and are bound by the investment documentation, the full amount of their investments (whether made jointly or separately) may be included for purposes of determining whether the investors are accredited or large accredited investors. If, however, the investment documentation does not bind both spouses, the investing spouse's eligibility determination may include only 50 percent of: (a) any investments held jointly with the individual's spouse; and (b) any investments in which the individual shares a community property or similar shared ownership interest with the individual's spouse.[14]

This definition is similar to that in the Accredited Natural Person Proposal.[15] As we stated in our March 9 Letter, we believe the Commission should harmonize the definition of joint investments for the Accredited Natural Person Proposal with the definition of joint investments currently utilized for Section 3(c)(7) funds under Rule

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[13] Advisers Act Rule 205-3(d)(1). Qualified clients include natural persons who immediately after entering into the advisory contract have at least $750,000 under the management of the investment adviser or have a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1.5 million at the time the contract is entered into. *See* Accredited Natural Person Proposal at 25, n.61. Alternatively, we believe the Commission should consider adopting the proposed thresholds for a large accredited investor as the standard for an accredited natural person and confirm that the offering may include no more than 35 non-accredited purchasers.

[14] *See* Proposing Release at 40; Proposed Rule 501(j).

[15] The Commission is continuing to consider whether to permit a spouse's assets to be included in any calculation for determining whether an investor satisfies the financial criteria. *Id.* at 40, n.101.

2a51-1 under the Investment Company Act.[16] We also believe the definition of joint investments in this Proposal should be harmonized with the definition in Rule 2a51-1.

Unlike in these proposals, in determining whether a natural person is a qualified purchaser, Rule 2a51-1(g)(2) provides that there may be included in the amount of his or her investments any investments held jointly with the person's spouse or any investments in which the natural person shares a community property or similar shared ownership interest with his or her spouse. The Commission provides no rationale for this different treatment of joint investments in either proposal. Moreover, the proposed definitions would needlessly complicate eligibility determinations by requiring investors and/or fund sponsors to make determinations about the legal characterizations of the assets of an investor based on the requirements of his or her state of residence, including whether or not an asset is considered community property. This complex requirement would likely lead to inconsistent application, which would not serve to further the Commission's goals. We believe that the "bright line" test in Rule 2a51-1 continues to be the most simple and rational approach, and we urge the Commission to harmonize the definitions in the proposals accordingly.[17]

4. The Reasonable Belief Standard in Rule 501(a) Should Be Maintained

The Commission notes in the Proposing Release that its experience indicates that some issuers may not have taken appropriate measures to satisfy their obligation under Rule 501(a) to form a reasonable belief that a prospective purchaser satisfied the definition of an accredited investor.[18] The Commission seeks comment as to whether it should take additional measures to help issuers understand their obligations, including whether to create a safe harbor in Regulation D that sets forth the type of investigation required for an issuer to reach a reasonable belief that a prospective purchaser satisfied the definition of accredited investor.

Issuers, particularly private funds, engage in numerous activities to satisfy the current requirements in Rule 501(a) of the Regulation D safe harbor. For example, they may obtain certain certifications via subscription agreements and questionnaires from prospective investors that the investor is properly qualified. They may also have developed the requisite reasonable belief from their or their affiliates' experience in previous business dealings with the investors or by other documentation completed by the investor. In addition, they may employ other methods depending on the facts and

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[16] *See* Rule 2a51-1(g)(2).

[17] If, however, the Commission chooses not to harmonize the definition of joint investments with Rule 2a-51-1, we encourage it to eliminate any immaterial differences in the two pending proposals' definitions. This approach will provide some consistency among Regulation D offerings.

[18] Proposing Release at 38. Rule 501(a) states that, "[a]ccredited investor shall mean any person who comes within any of the following categories, or who the issuer *reasonably believes* comes within any of the following categories, at the time of the sale of the securities to that person…." (emphasis added).

circumstances of the particular offering. Thus, creating a safe harbor to satisfy this obligation is unnecessary. In addition, a proscriptive list of requirements may create additional unnecessary burdens for fund issuers and their advisers.

5. A Fiduciary Adviser Exemption from Accredited Natural Person Standard Should Be Adopted

We take this opportunity to strongly reiterate the request in our March 9 Letter that the Commission adopt a fiduciary representative exception to the accredited natural person standard for investors who hire an SEC-registered investment adviser. The Commission's proposed accredited natural person standard is designed to provide assurance that an investor has a "level of knowledge and financial sophistication and the ability to bear the economic risk" of an investment in a Section 3(c)(1) fund, as demonstrated by the investor's investment experience and net worth or income.[19] We believe that the retention of a registered investment adviser is an appropriate proxy for an investor's own investment experience and satisfies the Commission's goals. In fact, the Commission appears to be seeking the type of investment experience possessed by advisers by adding an investment-based eligibility standard for natural persons in Section 3(c)(1) funds.[20] Accordingly, we urge the Commission to except from the accredited natural person standard investors whose Section 3(c)(1) fund investments are made by the SEC-registered investment advisers they retain, as fiduciaries, to manage their assets on a discretionary basis.[21]

As we stated in our March 9 Letter, an investment adviser is a registered investment professional that stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients.[22] As a fiduciary, an SEC-registered investment adviser's duty of care, loyalty, honesty, and good faith to act in the best interests of its clients provides substantial protections for its clients, including those invested in Section

[19] Accredited Natural Person Proposal at 18-19.

[20] Thus, for these purposes, we propose this exception for the Accredited Natural Person Proposal and not with respect to the current requirements for accredited investors under Regulation D.

[21] Advisers managing assets on a discretionary basis have the authority to make investment decisions on behalf of their clients. Such advisers may discuss potential private fund investments with their clients before making the investment, and clients will sign the subscription agreement and other documents as appropriate. In so doing, clients may acknowledge that the adviser is their representative during the course of the purchase of a fund investment. *See, e.g.,* Securities Act Rule 501(h)(3) (requirements for purchaser representative). A "purchaser representative" is a similar concept to the fiduciary exception we propose. The Commission has stated that purchaser representatives may in fact be investment advisers. *See Interpretive Release on Regulation D,* SEC Release No. 33-6455, 1983 WL 409415 (Mar. 3, 1983) at 7, n.24 (citing SEC no-action letters *Winstead, McGuire, Sechrest & Trimble* (pub. avail. Feb. 21 and Mar. 25, 1975) and *re Kenisa Oil Company* (pub. avail. May 6, 1982)).

[22] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 201 (1963).

3(c)(1) funds. The Commission's concern about these investors should be alleviated by the fact that investment advisers are obligated to place their clients' interests above their own. The Commission should acknowledge this protection and adopt this exemption.

Conclusion

We appreciate the opportunity to provide our views on these important issues. Please do not hesitate to contact the undersigned if the Commission or its staff has any questions or if we may provide any additional information regarding these matters.

Sincerely,

Monique S. Botkin

Monique S. Botkin
Senior Counsel

cc: Hon. Christopher Cox
Hon. Paul S. Atkins
Hon. Annette L. Nazareth
Hon. Kathleen L. Casey

Mr. John W. White, Director, Division of Corporation Finance
Mr. Andrew J. Donohue, Director, Division of Investment Management
Mr. Douglas J. Scheidt, Chief Counsel, Division of Investment Management
Mr. Robert E. Plaze, Associate Director, Division of Investment Management

Attachment

March 9, 2007

Via Electronic Filing

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles (Release No. 33-8766; IA-2576; File No. S7-25-06)

Dear Ms. Morris:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Commission's proposed anti-fraud rules applicable to advisers to certain pooled investment vehicles, including hedge funds, and proposed rules to increase the financial eligibility requirements for accredited investors in certain private investment vehicles.[2] The latter proposal would establish a new category of accredited investors called "accredited natural persons," which would require ownership of at least $2.5 million in "investments" in order to invest in certain Section 3(c)(1) funds.[3]

The IAA commends the Commission and its staff for addressing these important investor protection issues and supports the Commission's efforts to implement rules to protect investors in certain pooled vehicles from fraudulent conduct.[4] We agree that it is

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[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, SEC Release No. 33-8766; IA-2576; File No. S7-25-06 (Dec. 27, 2006) (Proposing Release or Proposal), available at http://www.sec.gov/rules/proposed/2006/33-8766.pdf, as published in 72 Fed. Reg. 400 (Jan. 4, 2007).

[3] Section 3(c)(1) funds are offered privately to 100 or fewer beneficial owners. We refer in our letter to Section 3(c)(1) funds generally. However, the Commission has proposed an exclusion from the new standard for investors in "venture capital funds," as defined in the Proposal. *See* Proposing Release at 30-33.

[4] Indeed, we supported the Commission's previous rulemaking to require investment advisers to hedge funds to register under the Investment Advisers Act of 1940, which would have provided important

critical for the Commission to retain its ability to bring enforcement actions against advisers that defraud hedge fund investors. We also support the Commission's efforts to modernize the 25-year old accredited investor standards under the Securities Act of 1933 to ensure that investors in certain private offerings are financially sophisticated enough to understand and bear the economic risk of those investments. A number of modifications are necessary, however, to ensure the proposals appropriately achieve the Commission's goals.

With respect to the proposed "accredited natural person" standard, we respectfully request that the Commission:

- Adopt a fiduciary representative exception to the accredited natural person standard for investors who hire an SEC-registered investment adviser;[5]
- Modify several provisions of the proposed accredited natural person standard, including: (a) conform the proposed accredited natural person standard to that of existing requirements for "qualified clients" under Rule 205-3 of the Advisers Act, or otherwise adjust the current accredited investor standard; (b) conform the definition of "investments" to the definition applicable to investor eligibility for Section 3(c)(7) funds;[6] and (c) eliminate the automatic indexing requirement of the proposed new standard;
- "Grandfather" future capital commitments of current investors in existing Section 3(c)(1) funds affected by the proposed rules;
- Add "knowledgeable employees" of Section 3(c)(1) funds and their advisers to the definition of accredited natural person; and
- Allow sufficient time for compliance with the proposed accredited natural person rules.

With respect to the proposed anti-fraud rule, we respectfully request that the Commission clarify that the proposed rule does not create any new liability under the Advisers Act for an investment adviser to an investment company.

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investor protections. *See* Letter from David G. Tittsworth, Executive Director and Caroline Schaefer, Associate General Counsel to Jonathan G. Katz, U.S. Securities and Exchange Commission (Sept. 14, 2004); *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, SEC Release No. IA-2266, File No. S7-30-04 (Dec. 4, 2004) ("Hedge Fund Adviser Registration Rule")).

[5] The Commission may wish to consider whether other fiduciary exceptions are appropriate.

[6] Section 3(c)(7) funds are offered privately to "qualified purchasers," as defined under the Investment Company Act.

A. Proposed Accredited Natural Person Standard for 3(c)(1) Funds

The Commission has proposed that investors in Section 3(c)(1) funds must: (1) meet the current accredited investor standards of having: (a) a net worth, or joint net worth with the person's spouse, exceeding $1 million at the time of purchase; or (b) individual income exceeding $200,000 (or joint income with the person's spouse of $300,000) in each of the most recent two years and an expectation of reaching the same income level in the year of investment;[7] *and* (2) own, individually, or jointly with that person's spouse, not less than $2.5 million (as adjusted for inflation) in "investments."[8] While we support the Commission's reassessment of the financial eligibility standards, we propose an important exception and several modifications as discussed below.

1. <u>Accredited Investors Who Hire a Registered Investment Adviser Should be Excepted from the Proposed Accredited Natural Person Standard</u>

The Commission's proposed accredited natural person standard is designed to provide assurance that an investor has a "level of knowledge and financial sophistication and the ability to bear the economic risk" of an investment in a Section 3(c)(1) fund, as demonstrated by the investor's investment experience and net worth or income.[9] We are concerned, however, that the rules as proposed will prevent investments in these funds by a large class of investors who are financially sophisticated enough to hire an investment adviser registered with the Commission to manage their assets on a discretionary basis.[10] We believe that the retention of a registered investment adviser is an appropriate proxy for an investor's own investment experience and satisfies the Commission's goals. In fact, the Commission appears to be seeking the type of investment experience possessed by advisers by adding an investment-based eligibility standard for natural persons in Section 3(c)(1) funds.[11] Accordingly, we propose that the Commission except from the accredited natural person standard investors whose Section 3(c)(1) fund investments are made by the SEC-registered investment advisers they retain, as fiduciaries, to manage their assets on a discretionary basis.[12]

[7] *See* Securities Act Rules 215(e),(f) and Rules 501(a)(5),(a)(6).

[8] Proposed Securities Act Rules 215(e),(f), 216, 501(a)(5), (a)(6), 509.

[9] Proposing Release at 18-19.

[10] The Commission has long treated accredited investors meeting the requirements under the Securities Act as sufficiently sophisticated to be able to make their own investment decisions. Certainly, such accredited investors are sophisticated enough to choose an investment adviser to make investment decisions for them.

[11] Thus, we propose this exception for the Commission's proposal to adopt an accredited natural person standard and not with respect to the current requirements for accredited investors under Regulation D.

[12] Advisers managing assets on a discretionary basis have the authority to make investment decisions on behalf of their clients. Such advisers may discuss potential private fund investments with their clients before making the investment, and clients will sign the subscription agreement and other documents as

The Commission's concern about these investors should be alleviated by the fact that SEC-registered investment advisers are obligated to place their clients' interests above their own. An investment adviser stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients.[13] As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients. The parameters of an investment adviser's duty depend on the scope of the advisory relationship and generally include: the duty at all times to place the interests of clients first; the duty to have a reasonable basis for its investment advice; the duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines, and restrictions; the duty to treat clients fairly; and the duty to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest.[14] These obligations of SEC-registered investment advisers provide substantial protections for their clients, including those invested in Section 3(c)(1) funds.[15]

Specifically, in the course of their duties, investment advisers conduct research and due diligence on certain hedge funds, private equity funds, and venture capital funds, among others, on behalf of their investors before making an investment in such fund for their clients. The recommendations or investments are vetted by advisers after satisfying their duties to make investment decisions in the best interest of their clients. In addition, advisers are required to understand the complexities and risks of any investment vehicle in which they invest their clients' assets. This unique relationship should satisfy the Commission that these investors are appropriately protected and able to accept the risk of those investments.

A similar concept, one of a "purchaser representative," is found in Regulation D under the Securities Act.[16] A purchaser representative is required to have such

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appropriate. In so doing, clients may acknowledge that the adviser is their representative during the course of the purchase of a fund investment. *See, e.g.*, Securities Act Rule 501(h)(3) (requirements for purchaser representative).

[13] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 201 (1963).

[14] *Id.; see also In re Arleen Hughes*, SEC Release No. 34-4048 (Feb. 18, 1948); IAA Standards of Practice, as amended February 28, 2006, available at: http://www.icaa.org/html/sop.html.

[15] In addition, SEC-registered advisers are subject to Commission inspections and examinations under the Advisers Act. They are also obligated to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act, review those policies and procedures annually, and designate a chief compliance officer to be responsible for administering the policies and procedures. *See* Rule 206(4)-7; *Compliance Programs of Investment Companies and Investment Advisers*, SEC Release Nos. IA-2204; IC-26299; File No. S7-03-03 (Dec. 17, 2003).

[16] Securities Act Rule 501(h). The Commission has stated that purchaser representatives may in fact be investment advisers. *See Interpretive Release on Regulation D,* SEC Release No. 33-6455, 1983 WL

knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment.[17] Likewise, a registered investment adviser has knowledge and experience in financial and business matters and is capable of evaluating, and does evaluate, the merits and risks of prospective investments in Section 3(c)(1) funds for its clients.[18]

Indeed, the Commission acknowledges in the Proposing Release that a similar category of natural person investors does not need the protection of a higher accredited investor standard:

> [N]atural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. *This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles.*[19] (emphasis added.)

We respectfully submit that a natural person's retention of a registered investment adviser provides the same level of protection as the pooled vehicle's retention of a plan fiduciary or "registered investment professional" cited with approval by the Commission.[20] Many natural persons have in fact retained registered investment advisers to make investments on their behalf, including in Section 3(c)(1) funds. Accordingly, the Commission should acknowledge this protection and adopt an exemption to the accredited natural person standard for natural person investors who hire an investment adviser registered with the Commission to manage their accounts on a discretionary basis.

409415 (Mar. 3, 1983) at 7, n. 24 (citing SEC no-action letters *Winstead, McGuire, Sechrest & Trimble* (pub. avail. Feb. 21 and Mar. 25, 1975) and *re Kenisa Oil Company* (pub. avail. May 6, 1982)).

[17] Securities Act Rule 501(h)(2).

[18] In addition, a purchaser representative is obligated to disclose to the purchaser in writing any material relationship between himself or his affiliates and the issuer or its affiliates that then exists or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship. Securities Act Rule 501(h)(4). Similarly, a registered investment adviser is required to make disclosures regarding material conflicts of interest it has in relation to its position for the accredited investor.

[19] Proposing Release at 18.

[20] *See also* President's Working Group on Financial Markets, *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, at section 5 (Feb. 22, 2007), which noted that fiduciaries that manage pension funds, fund-of-funds, or other similar pooled investment vehicles "have a duty under applicable law to act in the best interest of the beneficiaries. They have an ongoing responsibility to perform due diligence to ensure that their investment decisions are prudent and conform to sound practices for fiduciaries." Advisers, as fiduciaries, provide the same level of protection and similar functions with respect to their clients' investments.

2. The $2.5 Million Investments Threshold Should Be Modified

a. The Standard is Not an Appropriate Proxy for Financial Sophistication

The Commission has proposed that an accredited natural person must have $2.5 million in "investments," excluding personal residences, in order to invest in Section 3(c)(1) funds. We are concerned that this threshold may be higher than is necessary to achieve the Commission's goals and may have negative collateral consequences. One of the keys to reducing portfolio risk is diversification within and across asset classes. Many natural persons today, including clients of registered investment advisers, seek a variety of alternative investments, including hedge funds, private equity funds, and venture capital funds, as vehicles to greater diversify their portfolios. The Commission's approach seems to overlook the fact that certain investors and clients of investment advisers can afford to have – and choose to have – relatively illiquid investments in a segment of their portfolio. Thus, the proposed threshold may negatively affect responsible portfolio diversification. In addition, reducing the pool of available investors so significantly may unduly limit the creation of potential new funds while providing a competitive advantage to larger, existing pooled vehicles over smaller funds. For these reasons, we offer an alternative to the proposed $2.5 million in investments discussed below.

b. The Standard Should be Harmonized with the "Qualified Client" Standard under Advisers Act Rule 205-3

As an alternative to the proposal, we believe the Commission should consider harmonizing the accredited natural person standard with that of the $1.5 million net worth requirement applicable to "qualified clients" of an adviser that charges performance fees under Advisers Act Rule 205-3.[21]

We note that the proposed rules are designed to address a regulatory gap caused by the court's invalidation in *Goldstein v. SEC* of the Commission's rule requiring registration of certain hedge fund advisers.[22] Because virtually all hedge funds charge performance fees, that rule would have, in effect, required hedge fund investors to have $1.5 million in net worth by virtue of compliance with Rule 205-3. Thus, we suggest harmonizing the accredited natural person standard with the qualified client standard of $1.5 million net worth. This approach would also have the benefit of avoiding the

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[21] Advisers Act Rule 205-3(d)(1). Qualified clients include natural persons who immediately after entering into the advisory contract have at least $750,000 under the management of the investment adviser or have a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1.5 million at the time the contract is entered into. *See* Proposing Release at 25, n. 61.

[22] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (vacating and remanding Hedge Fund Adviser Registration Rule).

creation of yet another standard for eligibility in the securities laws – *i.e.*, adding "accredited natural person" to "accredited investor" under the Securities Act, "qualified client" under Advisers Act Rule 203-5, "qualified purchaser" under Investment Company Act Section 3(c)(7), "qualified institutional buyer" under Securities Act Rule 144A, and "qualified eligible persons" under CFTC Rule 4.7. The application of these differing standards is burdensome and complicated from a compliance standpoint.

Alternatively, if the Commission determines not to adopt the qualified client standard, the Commission should instead increase the thresholds of the current accredited investor standard under Securities Act rules, or increase the current accredited investor standard by excluding investors' personal residences in the net worth calculation.[23] This may be the simplest and easiest method to implement administratively and would achieve the Commission's goals.

c. "Joint Investments" Should Receive the Same Treatment as in Investment Company Act Rule 2a51-1

For purposes of the accredited natural person standard, the Commission proposes to treat investments of a natural person owned jointly with a spouse, or that are part of a shared community interest, differently than the treatment of such investments under Investment Company Act Rule 2a51-1 for Section 3(c)(7) funds. Specifically, the Commission proposes that for purposes of determining whether a natural person, acting on that person's own behalf (and not jointly with a spouse), should be able to qualify as an accredited natural person, the person's investments should include only *a portion* of the amount of any investments owned jointly, or of any investments which ownership is shared, with the person's spouse.[24]

In contrast, Rule 2a51-1 for Section 3(c)(7) funds permits all of such investments, rather than a portion, to be included in the determination of whether a natural person is a "qualified purchaser."[25] In determining whether a natural person is a qualified purchaser under Rule 2a51-1, the person may include investments held jointly with the person's spouse or any investments in which the natural person shares with his or her spouse a

[23] The Commission may coordinate these changes with any other amendments to Regulation D that the Division of Corporation Finance may be considering.

[24] The proposed rules provide that the investments of a natural person seeking to make an investment in a Section 3(c)(1) fund on his or her own behalf may include *only 50 percent* of the following: (a) any of the person's investments held jointly with that person's spouse; and (b) any investments in which the person shares a community property or similar shared ownership interest with that person's spouse. *See* Proposing Release at 28; Proposed Securities Act Rules 216(c)(4), 509(c)(4).

[25] *See* Proposing Release at 27-28.

community property or similar shared ownership interest.[26] In fact, the Commission stated in the release adopting Rule 2a51-1 that it "believes that th[e] approach [adopted] will simplify the determination of whether spouses making a joint investment are qualified purchasers." The Commission provides no rationale for this different treatment of joint investments for the accredited natural person standard.

Further, the proposal would require investors and/or fund sponsors to make determinations about the legal characterizations of the assets of an investor based on the requirements of his or her state of residence, including whether or not an asset is considered community property. This complex requirement would likely lead to inconsistent application, which would not serve to further the Commission's goals. Instead, we believe that the "bright line" test in Rule 2a51-1 should be adopted to assess the ownership of "investments" of an accredited natural person.

d. <u>An Automatic Inflation Adjustment is Inconsistent with Section 3(c)(7)</u>

The Commission has proposed to adopt a rule that would automatically index the $2.5 million for the amount of investments that a person would be required to own under the proposed definition of accredited natural person.[27] We prefer the Commission refrain from requiring automatic indexing for inflation, which may be more complicated and difficult to monitor than an absolute number as currently proposed. In addition, the Commission has not required indexing of the $5 million in investments that natural persons must own to be qualified purchasers eligible to invest in Section 3(c)(7) funds. We believe the Commission should retain the flexibility to reassess the "accredited natural person" criteria periodically and adjust it as necessary for inflation, market conditions, and other relevant factors.

3. <u>Current Section 3(c)(1) Fund Investors Should be "Grandfathered" for Future Investments in the Fund</u>

We understand the proposed rules would permit current accredited investors who would not meet the new accredited natural person standard to retain their existing investments in Section 3(c)(1) funds.[28] We request confirmation of our understanding in the final rules and the adopting release.

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[26] Investment Company Act Rule 2a51-1(g)(2). *See Privately Offered Investment Companies*, SEC Release No. IC-22597, File No. S7-30-96 (Apr. 3, 1997) at 34-35.

[27] *See* Proposing Release at pp. 23-24.

[28] *See* Proposing Release at 25. If our interpretation is incorrect, we strongly believe current investors should be grandfathered from application of the new accredited natural person standard and not required to divest their current holdings. We believe it would be unfair to current investors in Section 3(c)(1) funds and disruptive to the markets generally to require investors who do not meet the proposed accredited natural person standard to be required to dispose of their interests in the funds. In addition, the Commission's former rule requiring hedge fund advisers to register with the Commission would have

In addition, we urge the Commission to permit current investors in Section 3(c)(1) funds to continue to make future investments in these funds. In some instances, this is necessary to facilitate investors' investment or contractual obligations. Additional investments in these funds may be needed or desired to allow for the continuation of a long-standing investment plan or to implement an investor's periodic reallocation and rebalancing of his or her portfolio. In addition, certain closed-end Section 3(c)(1) funds have contractually obligated their investors to make capital commitments over the life of the fund. We also respectfully submit that it is a matter of fundamental fairness to permit future investments in the same fund for individuals who relied on existing and legitimate rules at the time of their initial investment.

4. Knowledgeable Employees Should Be Included in the Definition of Accredited Natural Persons

The rules as proposed may have the effect of precluding an employee of a Section 3(c)(1) fund or the fund's adviser from investing in the fund if he or she does not meet the accredited natural person standard, despite the fact that the employee may meet the definition of a "knowledgeable employee" as defined in Investment Company Act Rule 3c-5.[29] We believe the Commission should add to the list of accredited natural persons "knowledgeable employees" of Section 3(c)(1) funds and their advisers, as that term is defined in Rule 3c-5.[30]

The proposal, if adopted, would result in an unusual outcome whereby a knowledgeable employee may invest in a Section 3(c)(7) fund, which requires an investor to have $5 million in investments, but not invest in a Section 3(c)(1) fund, which would have a proposed threshold of $2.5 million in investments. Moreover, investors, and particularly institutional investors, expect employees of sponsors of Section 3(c)(1) funds to invest alongside the investor with a capital commitment demonstrating the sponsor and employees' dedication to the fund's success. In addition, these funds are often utilized to establish new investment products, and employees at advisers and sponsors are key participants in that process, frequently being the primary sources of seed capital for start-

amended Advisers Act Rule 205-3 to permit hedge fund advisers to charge performance fees to funds existing at the time of the adoption of the rule that had non-qualified investors, thereby "grandfathering" the current investors in the hedge funds at the time of the rule's adoption. *See* Hedge Fund Adviser Registration Rule, *supra* n. 4.

[29] Under Investment Company Act Rule 3c-5, knowledgeable employees are excluded from the 100-beneficial owner limit for Section 3(c)(1) funds and are excluded from the requirement that only qualified purchasers own Section 3(c)(7) funds.

[30] The Commission may also wish to take this opportunity to consider exempting "knowledgeable employees" from the current accredited investor standards under Regulation D for Section 3(c)(1) and 3(c)(7) funds. Individuals who participate in the investment activities of these private funds would have a substantial understanding of the fund, its structure, and its risks such that the "knowledgeable employee" standard may serve as a substitute for the current accredited investor standard.

up funds. Finally, with the adoption of Investment Company Act Section 3(c)(7), the Congress directed the Commission to draft rules permitting knowledgeable employees to invest in Section 3(c)(1) funds without being counted toward the 100-beneficial owner limit. Clearly, such a concept should apply to these proposed standards. Accordingly, we urge the Commission to add "knowledgeable employees" of a Section 3(c)(1) fund, or adviser of the fund, to the list of accredited natural persons.

5. A Compliance Date of One Year Should Be Adopted

The proposed rules present a significantly different method for assessing eligibility for investors in Section 3(c)(1) funds. If the Commission chooses not to permit grandfathering of current investors so that they may remain invested and make future contributions, Section 3(c)(1) funds and their sponsors will need to determine whether the funds can continue operations without this same large pool of available investors and whether their current investors will be eligible to continue to invest in the funds. In this regard, funds and their sponsors will need to obtain representations about the investments owned by the investor and his or her spouse, including whether the investments are held jointly. Even if current investors are grandfathered, funds will need to revise their subscription documents and processes to incorporate the new accredited natural person standard. Accordingly, in order to comply with the proposed requirements to evaluate investor eligibility, we believe advisers or sponsors to Section 3(c)(1) funds would likely need a one-year compliance date from the effective date of the rule.

B. Proposed Anti-Fraud Rule for Advisers to Pooled Investment Vehicles

Proposed anti-fraud Rule 206(4)-8(a)(1) provides that an adviser to a "pooled investment vehicle" will commit a fraudulent act if it makes any untrue statement of a material fact or omits to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle. Proposed Rule 206(4)-8(a)(2) makes it a fraudulent act to otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. A "pooled investment vehicle" is defined to mean any investment company as defined in Section 3(a) of the Investment Company Act or any Section 3(c)(1) or Section 3(c)(7) fund.

We strongly support the Commission's goal of deterring and punishing conduct that defrauds investors or prospective investors in hedge funds and other similar funds but believe the Commission's objectives are best served by a more targeted approach. We are concerned that the proposed anti-fraud rule is duplicative of enforcement remedies currently available under Section 34(b) of the Investment Company Act for an investment adviser to an investment company. The Commission acknowledges that it believes, "as a general matter, most advisers that advise registered investment companies will, to a large extent, communicate with investors and prospective investors in those funds through documents that are already subject to section 34(b)." The proposed rule is also duplicative of remedies under Advisers Act Sections 206(1) and 206(2) and Securities Act Section 17(a).[31] Duplication is unnecessary and could result in differing or inconsistent interpretations and enforcement practices. Thus, we request that the Commission better target its approach and remove from the definition of "pooled investment vehicle" an investment company defined in Section 3(a) of the Investment Company Act.

Alternatively, we request that the Commission clarify in the adopting release that the proposed rule does not create any new liability for investment advisers to investment companies not already provided for in Advisers Act Sections 206(1) or 206(2) or Investment Company Act Section 34(b).

Conclusion

We commend the Commission for seeking to protect investors in hedge funds. In so doing, the Commission should adopt a fiduciary adviser exemption from the proposed accredited natural person standard and our other recommended enhancements to the proposals.

We appreciate the opportunity to provide our views on these important issues. Please do not hesitate to contact the undersigned if the Commission or its staff has any questions or if we may provide any additional information regarding these matters.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

Monique S. Botkin

Monique S. Botkin
Counsel

cc: Hon. Christopher Cox
Hon. Paul S. Atkins
Hon. Roel C. Campos
Hon. Annette L. Nazareth
Hon. Kathleen L. Casey

Mr. Andrew J. Donohue, Director, Division of Investment Management
Mr. Robert E. Plaze, Associate Director, Division of Investment Management
Mr. Douglas J. Scheidt, Chief Counsel, Division of Investment Management

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[31] Indeed, we submit that, notwithstanding the *Goldstein* decision, the Commission has sufficient enforcement authority with respect to misconduct by investment advisers registered under the Advisers Act.

November 2, 2007

Via Electronic Filing

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Interpretive Rule under the Advisers Act Affecting Broker-Dealers, Rel. No. IA-2652, File No. S7-22-07

Dear Ms. Morris:

The Investment Adviser Association[1] appreciates the opportunity to submit comments on a proposed interpretive rule that would address the application of the Investment Advisers Act of 1940 to certain activities of broker-dealers.[2] The proposal would reinstate three interpretive provisions of the Commission's rulemaking relating to the broker-dealer exception under the Advisers Act, which was invalidated by the D.C. Circuit Court of Appeals earlier this year.[3] The IAA supports the Commission's reinstatement of these interpretive positions, with comments and modifications with respect to certain aspects of the proposal as discussed below. In addition, we re-emphasize below our previous comments related to investor education and the RAND study.[4]

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[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of about 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, Rel. No. IA-2652 (Sept. 24, 2007) (Proposal).

[3] *See Financial Planning Association v. S.E.C.*, 2007 WL 935733, C.A.D.C. (Mar. 30, 2007) (vacating Advisers Act rule 202(a)(11)-1 adopted in *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Rel. Nos. IA-2376; 34-51523; File No. S7-25-99 (Apr. 12, 2005)("Final Rule")).

[4] When the Commission approved the Final Rule in April 2005, it also directed Commission staff to report on "any rulemaking action that the staff would be prepared to recommend that the Commission undertake in the near term," as well as options and recommendations for a study "to compare the levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act…" In June 2006, the Commission issued a Request for Information for "a study that will involve collecting, categorizing and analyzing empirical data regarding the marketing, sale, and delivery of financial products, accounts, programs and services offered to individual investors by broker-dealers and investment advisers."

Discretionary Management

The IAA has been actively involved in this rulemaking since its inception in 1999. Throughout the debate involving this rule, the IAA has consistently taken the position that discretionary investment management cannot be deemed to be "solely incidental" to brokerage services.[5] We commended the Commission for the aspect of the rule it adopted in 2005 confirming that discretionary advice provided on a commission basis is not "solely incidental" to brokerage services.[6] In response to the court's ruling, we, along with other groups, urged the Commission to: (i) provide guidance to brokers on their obligations, given the court's decision, and information to investors about implications of the court decision while a more permanent policy is being developed; and (ii) reaffirm pro-investor aspects of the rule that were not overturned by the court, including the position that discretionary management services are not solely incidental to brokerage services.[7] Accordingly, we strongly support the proposed interpretive rule confirming that discretionary investment advice is not solely incidental to the business of a broker-dealer, regardless of the form of compensation charged.

We continue to be concerned, however, with the Commission's exception from this interpretation for situations where the broker has discretion over an account during a client's vacation or other limited period of time.[8] Discretionary management over an account "for a few months" should not be deemed to be an activity that is solely incidental to brokerage services. Further, as we discussed in our 2005 comment letter,[9] a client's decision to grant such authority to a broker even for a limited period is indicative of the type of relationship of

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Request for Information/Draft Solicitation, SEC Rel. No. 34-54077 (June 30, 2006). In September 2006, the Commission awarded the contract to RAND to conduct this study. *See* Press Release, "SEC Awards Contract for Study to Compare Roles of Investment Advisers, Broker-Dealers," Rel. No. 2006-162 (Sept. 26, 2006).

[5] *See, e.g.,* Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan G. Katz, Secretary, SEC (Jan. 12, 2000); Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan G. Katz, Secretary, SEC (Feb. 7, 2005) ("Feb. 7, 2005 Letter").

[6] *See* Final Rule.

[7] *See* Letter from David G. Tittsworth, Investment Adviser Association, Consumer Federation of America, Financial Planning Association, Fund Democracy, National Association of Personal Financial Advisors, and North American Securities Administrators Association, to the Honorable Christopher Cox, Chairman, SEC (Apr. 24, 2007). We incorporate that letter by reference here. *See also* Letter from Karen L. Barr, Investment Adviser Association, to Andrew J. Donohue, Director, SEC Division of Investment Management (July 3, 2007) ("It is important that the Commission retain investor protections in whatever rulemaking or interpretation will be provided in response to the court's ruling").

[8] Proposal at n.13 (stating the Commission's view that it would consider discretion to be temporary or limited under seven circumstances, including when the broker is given discretion "on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time not to exceed a few months").

[9] Feb. 7, 2005 Letter, *supra* n.5.

trust and confidence that may confer a fiduciary duty on the broker.[10] Such clients should be accorded the fiduciary protections of the Advisers Act.

In addition, the proposed rule language pertaining to this interpretation appears less precise than it was in the vacated rule. Accordingly, we respectfully suggest the following modification to the proposed rule text in subsection (a)(2): "Exercises investment discretion (as that term is defined in section 3(a)(35) of the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S. C. 78c(a)(35)) *with respect to any account*, except investment discretion granted by a customer *only* on a temporary or limited basis over such account." (*emphasis added on proposed modifications).*[11]

Investor Education and Protection

As we stated in previous correspondence to the Commission, we believe the Commission can and should play a much more proactive role in educating investors and consumers about the fundamental issues involved in this rulemaking.[12] The Commission's Office of Investor Education and Advocacy, for example, should take a leading role in developing and providing educational information to the public about the confusion that arises when broker-dealers provide investment advice to their customers. As the Commission's own focus groups have revealed, investors are "generally confused about the distinctions between brokers, financial advisors/consultants, investment advisers and financial planners."[13] Accordingly, we recommend that the Commission take this opportunity to inform investors and the public about the differences between brokerage and advisory activities, the laws and regulations governing each, and specific issues raised by this and the principal trade rulemakings. We strongly believe the Commission must play a central role in educating the investing public about these important issues and we stand ready to assist the Commission in any way that may be helpful.[14]

In addition, Chairman Cox has announced that the RAND study of the marketing, sale, and delivery of financial products and services to investors in this area will be accelerated so

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[10] *See* Final Rule at n.98 and accompanying text.

[11] Consistent with our comments above, this proposed language is submitted subject to modification of the SEC's proposed interpretation of "temporary or limited basis."

[12] Letter from David G. Tittsworth, Investment Adviser Association, to the Honorable William H. Donaldson, Chairman, SEC (June 22, 2005).

[13] *Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosure*, SEC (Mar. 10, 2005), at 8.

[14] Last year, for example, we worked with state regulators, consumer groups and others in publishing an investor education brochure called "Cutting through the Confusion." After a meeting with the Office of Investor Education in October 2006, various links to the brochure were included on the Commission's web site. Linking the brochure on the web site was a positive first step in educating investors. Unfortunately, the links to this investor education piece have recently been removed. Reinstating references to the educational brochure would assist in providing helpful information to investors about issues they confront when engaging the services of an investment professional.

that it is delivered to the Commission no later than December 2007.[15] He noted that the results of the study are expected to provide an "important empirical foundation for considering improvements" in this regulatory area.[16]

We have previously outlined some of our concerns related to the proposed study.[17] We believe it is crucial for the Commission to focus its resources on clarifying the distinctions between advisers, brokers and planners, on educating investors about these distinctions, and on protecting investors by enforcing the law in these areas. We would welcome the opportunity to work with the Commission and its staff in connection with future rulemaking in this area or evaluation of the RAND study and any ensuing Commission action related to these important issues.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

cc: Hon. Christopher Cox
Hon. Paul S. Atkins
Hon. Annette L. Nazareth
Hon. Kathleen L. Casey

Andrew J. Donohue, Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management

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[15] *See* Press Release, "Commission Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts," Rel. No. 2007-95 (May 14, 2007) ("2007 Press Release").

[16] 2007 Press Release.

[17] *See* n.12, *supra*.

November 30, 2007

Via Electronic Filing

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Rel. No. IA-2653, File No. S7-23-07

Dear Ms. Morris:

The Investment Adviser Association[1] appreciates the opportunity to submit comments on temporary rule 206(3)-3T, which enables broker-dealers also registered as investment advisers to engage in certain principal transactions in non-discretionary accounts, subject to several conditions.[2] The interim rule establishes an alternative means for those broker-dealers to meet the requirements of Section 206(3) of the Investment Advisers Act of 1940.[3] As noted below, we believe the Commission has struck an appropriate balance, although we would strongly oppose expansion of the terms or conditions of the temporary rule.

Section 206(3) makes it unlawful for any investment adviser, directly or indirectly "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction." An adviser entering into a principal transaction with a client must satisfy these disclosure and consent requirements on a transaction-by-transaction basis. Section 206(3) was enacted to address concerns that an adviser might undertake principal transactions

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the Association's current membership consists of more than 500 firms that collectively manage in excess of $8 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, SEC Rel. No. IA-2653 (Sept. 24, 2007) ("Temporary Rule Release").

[3] The interim rule was adopted in response to the decision by the D.C. Circuit Court of Appeals earlier this year that invalidated the SEC's rule providing that fee-based brokerage accounts were not advisory accounts and were not subject to the Advisers Act. *See Financial Planning Association v. S.E.C.*, 2007 WL 935733, C.A.D.C. (Mar. 30, 2007) (vacating Advisers Act rule 202(a)(11)-1 adopted in *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Rel. Nos. IA-2376; 34-51523; File No. S7-25-99 (Apr. 12, 2005)).

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with clients in order to engage in self-dealing or to dump unmarketable securities or securities that are declining in value.[4]

The IAA commends the Commission for narrowly tailoring the interim rule so that it solely provides limited relief with respect to investors in certain non-discretionary accounts.[5] Because of the risks associated with principal transactions, an expansive exception to the principal trading restrictions would be unwarranted. Congress's concerns regarding the risks inherent in principal transactions were and continue to be significant.[6] As noted by the Commission in the Temporary Rule Release, "Self-dealing by investment advisers involves serious conflicts of interest and a substantial risk that the proprietary interests of the adviser will prevail over those of its clients."[7]

The IAA also commends the Commission for adopting the interim rule on a temporary basis.[8] The temporary nature of the rule will enable the Commission to carefully consider and respond to comments and assess the operation of the rule.[9] In light of the sunset provision, we expect the staff to conduct a thorough analysis of whether the rule is working, including monitoring both how firms comply with their disclosure obligations and whether firms that conduct principal trades with their clients serve the best interests of their clients.[10] Such review and evaluation of the temporary rule is essential. We respectfully urge the Commission to dedicate adequate resources to ensure that the rule is properly implemented and to ensure that dual registrants comply fully with its requirements. The Commission's review is needed in order to guarantee compliance with the rule on a temporary basis, to protect clients, and to fully inform the Commission as to any future rulemaking decisions.[11]

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[4] Temporary Rule Release at 13.

[5] The requirements set forth in the interim rule include: providing advanced written disclosure of conflicts, obtaining written revocable consent from the client, providing certain disclosures and obtaining consent before each principal trade, sending client confirmation statements, and delivering an annual report itemizing the principal trades. *Id.*, at 14-15.

[6] *Id.*, at 14.

[7] *Id.*

[8] Absent further action by the SEC, the temporary rule will expire on December 31, 2009. *Id.*, at 1.

[9] *Id.*, at 38-39.

[10] *See* Andrew J. Donohue, "Keynote Address at the 2007 Managed Account Solutions Conference" (Oct. 19, 2007) available at http://sec.gov/news/speech/2007/spch101907ajd.htm ("[The sunset provision] gives the Commission and the staff an opportunity to observe how firms comply with their disclosure obligations under the rule, and whether, when they conduct principal trades with their clients, they serve their clients' best interests."). *See also* Temporary Rule Release at 13 and 31.

[11] The results of the RAND study of the marketing, sale and delivery of financial products and services to investors are expected to be part of that evaluation. *See* Press Release, "Commission Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts," Rel. No. 2007-95 (May 14, 2007) ("The results of the study are expected to provide an important empirical foundation for considering improvements in [this regulatory area]").

Furthermore, the Commission should carefully evaluate the interim rule by taking into account the purpose and intent of Section 206(3). Any further exemption from the provisions of the Advisers Act could lead to a "slippery slope," whereby the principal trading protections set forth in the Advisers Act eventually are completely eroded. In addition, evaluation of the interim rule should take into consideration long-established, core legal and regulatory distinctions between investment advisers and broker-dealers to ensure that the statutory distinctions between brokerage activities and investment advisory services remain intact.[12]

Finally, we also encourage the Commission to use this opportunity to play a proactive and prominent role in educating investors and consumers about the fundamental issues involved in this and related rulemakings. As we have stated in prior correspondence, we recommend that the Commission actively provide notice and information to investors about the differences between broker-dealers and investment advisers, and the laws and activities governing each.[13] Such information should include educational materials regarding principal trades, including the interim rule. We continue to strongly believe that the Commission must play a central role in educating the investing public about these critical issues.

We welcome the opportunity to work with you and continue our discussions regarding these matters.

Sincerely,

Valerie Baruch

Valerie Baruch
Assistant General Counsel

cc: Hon. Christopher Cox
Hon. Paul S. Atkins
Hon. Annette L. Nazareth
Hon. Kathleen L. Casey

Andrew J. Donohue, Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management

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[12] *See, e.g.,* Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan G. Katz, Secretary, SEC (Jan. 12, 2000).

[13] *See, e.g.,* Letter from David G. Tittsworth, Investment Adviser Association, to the Honorable William H. Donaldson, Chairman, SEC (June 22, 2005). *See also,* Letter from Karen Barr, Investment Adviser Association, to Nancy Morris, Secretary, SEC (Nov. 2, 2007). In 2006, the North American Securities Administrators Association, Consumer Federation of America, IAA, CFA Institute, and Financial Planning Association published a brochure, entitled "Cutting Through the Confusion," that provides helpful information to consumers about the differences between various investment services providers. In October 2006, the SEC established various links to the brochure as part of its Investor Education information (via NASAA's web site). Earlier this year, however, the SEC removed the links to the consumer brochure. Restoration of such links on the SEC web site would be a small, but positive, step toward enhanced investor education.

INVESTMENT ADVISER
ASSOCIATION

December 18, 2007

Via Electronic Filing

The Honorable Henry Paulson
Office of the Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Review by the Treasury Department of the Regulatory Structure Associated with Financial Institutions, TREAS-DO-2007-0018

Dear Secretary Paulson:

The Investment Adviser Association (IAA)[1] appreciates the opportunity to respond to the Treasury Department's request for comments in conjunction with its review of the regulatory structure associated with financial institutions.

We commend the Department for undertaking this review of "ways to improve efficiency, reduce overlap, strengthen consumer and investor protection, and ensure that financial institutions have the ability to adapt to evolving market dynamics, including the increasingly global nature of financial markets." The amount and pace of change occurring in the financial services industry is dramatic, and the IAA believes it is both timely and appropriate for the Department – working closely with other regulators and policy makers – to evaluate the current regulatory framework.

Our framework for evaluating the regulatory structure associated with financial institutions is influenced by our extensive experience with the Investment Advisers Act of 1940 (Advisers Act),[2] the law that provides the statutory basis for Securities and Exchange Commission (SEC) regulation of investment advisers. The IAA was founded in 1937 as the SEC was studying the fledgling investment advisory profession and Congress was considering legislation for the mutual fund and advisory industries. We worked closely with Congress to craft the Advisers Act and we have been working with the SEC in the ensuing decades on a wide variety of regulatory issues. In fact, the IAA's standards of practice were cited by the U.S. Supreme Court in its 1963 decision that held

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the IAA's membership today is comprised of more than 500 firms that collectively manage in excess of $9 trillion for a wide variety of institutional and individual clients. For more information, please see www.investmentadviser.org.
[2] Public Law No. 76-768, 54 Stat. 847.

that an investment adviser is subject to a fiduciary duty under the Advisers Act.[3] In 1996, we supported legislation that allocated regulatory oversight of investment advisers between the SEC and state regulatory authorities.[4] Today, we continue to work with the Congress, the SEC, and other regulators on a broad range of legislative, regulatory and policy issues that affect our membership and the investment advisory profession.

We are pleased to provide the following general comments relating to the review as well as our responses to specific questions posed by the Department.

Investment Adviser Regulation and Fiduciary Duty

In general, we believe the statutory and regulatory framework governing the advisory profession is sound. As discussed in greater detail below, the Advisers Act is a principles-based statute that broadly prohibits fraud, imposes a strict fiduciary duty on investment advisers, and grants the SEC broad authority to issue rules and regulations consistent with the goals of the statute. We believe the strong investor protection aspects of the Advisers Act have served both the investing public and our profession well and could serve as a model for regulation of other financial institutions. Further, we believe that the fiduciary culture fostered by the Advisers Act (as opposed to a sales culture in other financial services) has been a key – and largely successful – element in the regulatory framework governing our profession.

Efficacy of SEC as Primary Regulator

We also believe the role of the SEC as primary regulator of the investment advisory industry is critically important in terms of reducing inefficiencies associated with multiple regulators, providing a system that fosters accountability of the regulator, and encouraging subject matter expertise. As a corollary to our support for a single primary regulator, we have strongly opposed the creation of a self-regulatory organization (SRO) for the advisory industry. There is no compelling evidence that an SRO is needed to deal with any broad concerns arising from the advisory profession or that it would enhance investor protection. Factors that led to the establishment of other SROs are not present in the advisory profession (for example, the level of interconnectivity among broker-dealers that has been cited as a key reason for an SRO to provide a regulatory framework for dealing with policy and technical issues).

Indeed, the creation of an SRO for investment advisers would create an unnecessary layer of cost and bureaucracy without any commensurate investor protection benefits. The record of current SROs to anticipate and deal with major investor protection issues is, at best, mixed. As noted below, investment advisers have experienced a proliferation of regulatory requirements and increasing costs related to regulatory compliance during the past few years. For these and other reasons, we

[3] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) (*Capital Gains).* Our current standards of practice are available at our website at www.investmentadviser.org
[4] National Securities Markets Improvement Act, Public Law No. 104-290.

continue to strongly oppose subjecting the advisory profession to additional regulation by an SRO.

While we believe the statutory and general regulatory framework for our profession is appropriate, we certainly have concerns about various aspects of current regulation. In broad terms, our concerns fall into three categories: (1) the costs of regulation for both large and small investment advisory firms; (2) the lack of a cohesive functional regulatory approach to address issues that arise when different financial institutions engage in the same activity (such as providing investment advice); and (3) specific regulatory and implementation concerns.

Diversity of Investment Adviser Profession

Our concerns relating to the current regulatory structure are complicated by the fact that the investment advisory profession is extremely broad and diverse – an important fact that is often misunderstood. There are more than 10,000 SEC-registered investment advisers, representing a very broad spectrum of firms. For example, there are a few relatively large firms that oversee the lion's share of assets under management – 472 investment advisory firms (less than 0.5 percent) have investment management authority with respect to 84 percent of the $34 trillion in discretionary assets managed by all SEC- registered advisers.[5] Many of these larger firms are affiliated with other investment advisers, banks, broker-dealers, and insurance companies. However, the vast majority of investment advisory firms are quite small.[6] SEC data reflect that 90 percent of all federally registered investment adviser firms have fewer than 50 employees and 68 percent (more than 7,000 firms) have ten or fewer employees.[7]

Investment advisers manage assets for a wide array of individual and institutional investors, including high net worth clients, educational institutions, endowments and foundations, corporations, mutual funds, pension plans, hedge funds, banks, and state and local governments. Advisory firms employ a variety of investment strategies on behalf of their clients. While there is enormous disparity and complexity among different types of investment adviser firms, a core characteristic emerges. Of the 10,446 investment advisers that were federally registered as of April 2007, 6,924 – or 66.3 percent – were not engaged in any business activity other than giving investment advice.[8] Another core distinguishing characteristic is that most investment advisers have discretionary authority to make investment decisions on behalf of their clients (consistent with the terms of the advisory contract between the adviser and its client).

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[5] *See, e.g.,* IAA/NRS, *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* at 5-6 (Aug. 2007), available on our website.
[6] *Id*. More than 83% of SEC-registered advisory firms manage less than $1 billion in assets.
[7] *Id.*
[8] *Id*. 8-9. Only 628 investment advisers (6 percent) are dually registered as broker-dealers. In addition, 436 advisers (4.2%) are registered as a futures commission merchant, commodity pool operator or commodity trading adviser; 87 advisers (0.8%) are real estate brokers, dealers or agents; 1,266 advisers (12.1%) are also insurance brokers or agents; 52 advisers (0.5%) are either a bank or a separately identifiable department or division of a bank; and 2,569 advisers (24.5%) sell products or provide services other than investment advice to advisory clients.

As noted in further detail below, we have serious concerns that numerous other financial institutions – including brokers, banks, and unregistered hedge fund managers – are engaged in providing investment advice and yet are subject to significantly different standards and regulations than those imposed on investment advisers registered under the Advisers Act. Understandably, the blurring of lines resulting from such regulatory variations results in great confusion among consumers. In a more functional approach to regulation, similar activities would be treated similarly without regard to the type of financial institution involved.

There is no question that the variation among advisory firms presents a challenge to the SEC. As the primary – and in most cases, the sole – regulator for investment advisers, the SEC must be cognizant of the varying characteristics of firms in fashioning any rules or regulations as well as in implementing oversight and inspection programs that are tailored to fit the profession. While the task may be difficult, we nonetheless believe it is critical for the SEC to have full knowledge of the many variations among advisory firms in order to fashion appropriate policies and regulations and to implement reasonable inspection programs – all with the overarching goal of protecting investors.

Costs of Regulation

It should come as no surprise that we have significant concerns about the cost of regulation. During the past few years, the costs of compliance for the investment advisory profession have escalated dramatically.[9] These increasing costs have been the result of a number of new and significant regulations, including the compliance program rule,[10] as well as an aggressive expansion of the SEC inspection program.

Another significant cause of regulatory costs – particularly for larger advisory firms – is the interplay of many regulators, both in the U.S. and internationally. These regulators have different regulatory and enforcement philosophies and overlapping inspection and examination jurisdiction. One firm may be subject to requests and visits from multiple examination teams from different agencies simultaneously. We strongly recommend a process by which financial services regulators coordinate with each other regarding examination schedules. Similarly, regulators should work together to compare inconsistent or overlapping regulatory requirements with a goal of preventing unnecessary regulatory overload. Large firms also face substantial compliance costs based on the sheer size of their operations and the resources necessary to support compliance with the various requirements. One seemingly simple regulatory requirement from one agency may require that firms redesign and reprogram their entire document

[9] *See, e.g.*, IAA Costs of Compliance Survey (Nov. 2005).

[10] 17 C.F.R. §275. 206(4)-7 (compliance program rule). The compliance program rule, adopted by the SEC on December 3, 2003, requires an adviser to maintain written, comprehensive compliance programs. Specifically, the compliance program rule requires an adviser to: (1) adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act; (2) review the policies and procedures at least annually to determine their adequacy and effectiveness of their implementation; and (3) designate a chief compliance officer responsible for administering the policies and procedures.

management systems to capture one additional piece of information from thousands of employees.

For the smaller investment advisers that comprise the great majority of firms, significant regulatory compliance costs arise from the application of rules and regulations that also apply to the largest advisory firms. The same rules that apply to a multinational adviser with thousands of employees in multiple offices also apply to a three-person shop or sole proprietor and the cost of compliance is a significant factor in that firm's ability to operate. Even where the SEC provides flexibility in the rules for firms to tailor their compliance efforts to the specific characteristics and practices of the firm, that flexibility may be effectively eviscerated in actual practice. For example, the SEC compliance program rule is written flexibly, allowing firms to tailor their programs according to the nature of their business and clientele and allowing smaller firms to exercise judgment as to how systems and controls are implemented. In practice, however, the SEC's expectations – formed in the context of what larger firms are able to provide – may cause those judgments to be questioned during SEC inspections. Indeed, it is common for SEC inspections to commence with the same 27-page document request letter – whether the firm is a sole proprietor managing $25 million in assets or a global financial services firm managing hundreds of billions in assets.

We certainly recognize that there is no silver bullet for achieving regulatory perfection. For example, while we strongly support having a single regulator for the investment advisory profession, we understand that such a system alone does not necessarily resolve all regulatory problems. While the regulatory framework is of vital importance (including such key characteristics as defining the purposes and goals of regulation, achieving equitable treatment of various market participants, implementing effective programs that achieve the desired purposes and goals, ensuring that the regulatory structure can respond to changes in the marketplace, providing for appropriate accountability of the regulator, and ensuring that regulation is cost-effective), the manner in which regulation is implemented may be as important as the regulatory framework itself.

Regulatory Reform Process Must be Open and Inclusive

Many of the major U.S. securities laws, including the Advisers Act, were written many decades ago and it is certainly appropriate to examine whether they should be revised to keep pace with the significant developments that have taken place in the financial services industry since the laws were enacted. We strongly believe, however, that any such process of examining major revisions to the laws and regulations governing financial institutions must be open, transparent, and inclusive. While this review may represent a first step in such a process, it is obvious that further consideration of these important issues will require a collaborative process among all relevant regulators, Congress and other policy makers, affected industries, as well as investors and consumers. The IAA stands ready to assist the Department in any such initiative in seeking to create a more effective, workable, and cost-efficient regulatory structure.

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Given our constituency, our responses to the following specific questions raised by the Department are focused on the investment advisory profession and the Advisers Act.

1.1 "What are the key problems or issues that need to be addressed by our review of the current regulatory structure for financial institutions?"

As noted above, our primary concerns fall into three broad categories: (1) the costs of regulation for both large and small investment advisory firms; (2) the lack of a cohesive functional regulatory approach to address issues that arise when different financial institutions engage in the same activity (such as providing investment advice); and (3) specific regulatory and implementation concerns.

In addressing these and other issues, we respectfully suggest that the Department must first examine the purposes and goals of regulation, whether the current statutory and regulatory framework is appropriate for each financial institution, and whether the current framework has had effective results.

Apart from various issues relating to functional regulation, discussed in greater detail below, we believe the current statutory framework for investment advisers is essentially sound. The primary foundation of the U.S. securities laws – investor protection, the maintenance of fair, orderly, and efficient markets, and the facilitation of capital markets – is as appropriate and compelling today as when the SEC was established in 1934. The imposition of a strict fiduciary responsibility under the Advisers Act is an integral standard that serves the goal of protecting investors and fosters a culture within the advisory profession based on placing the client's interests first and eliminating or disclosing conflicts of interest. The Advisers Act also features broad anti-fraud provisions that grant the SEC authority to regulate, inspect, and enforce violations of applicable laws and regulations.

We believe the Department should examine the history, purposes, structure, and results of the Advisers Act in conducting its review. Such a review may lead the Department to conclude, for example, that the fiduciary standards imbedded in the Advisers Act should be extended to other financial institutions, particularly if such financial institutions provide investment advice.

Other key issues facing investment advisory firms include duplicative and inconsistent regulation for firms that are affiliated with other financial institutions or that offer multiple products or services and increasing compliance costs. We believe that an examination of Advisers Act regulations, including the benefits and costs thereof, is warranted.[11] This review should include a focus on the costs of regulation on small

[11] *See, e.g.*, "The Cost of Regulation Study" commissioned by the UK's Financial Services Authority and completed by Deloitte in 2006, which addresses the costs financial services firms incur in complying with the Financial Services and Markets Act 2000. John Tiner, the FSA's chief executive, explained the

investment advisory firms.[12] While we commend the Department for undertaking this review, we must note that addressing these issues will require coordinated action with the SEC.

1.2 "Over time, there has been an increasing convergence of products across the traditional 'functional' regulatory lines of banking, insurance, securities, and futures. What do you view as the significant market developments over the past two decades (e.g. securitization, institutionalization, financial product innovation and globalization) and please describe what opportunities and/or pressures, if any, these developments have created in the regulation of financial institutions?"

We agree that there has been increasing convergence of products – and services – offered by a variety of financial institutions. As discussed in greater detail below, our primary concern relates to different financial institutions offering investment advice.

We can point to at least four major developments that have contributed to convergence among financial institutions that provide investment advice: (1) the advent of electronic and alternative trading systems that have transformed traditional securities execution service providers; (2) demographic and economic trends in the U.S. that are creating unprecedented growth in the demand for investment advisory services; (3) increasing globalization in financial services activities; and (4) advances in technology.

There is no dispute that the traditional business of broker-dealers, *i.e.*, effecting securities transactions, has changed dramatically during the past few years. The creation of electronic trading and alternative systems has had a significant impact on the traditional broker-dealer business. Historically, the economics of the broker-dealer model were based on commissions received for buying or selling securities. During the past few years, however, commissions for many traditional execution services have declined as many competitors to full-service brokerage firms have emerged.[13] As a result, many brokers have begun to focus on providing investment advice to investors.[14]

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background of the study saying, "We are determined to strike the right balance between discharging our statutory duties and avoiding unjustified costs. We can do this only with a sound understanding of both the benefits and the costs of regulatory action." *The Cost of Regulation Study,* Deloitte 1 (June 28, 2006).

[12] As of April 6, 2007, there were 10,446 entities registered with the SEC as investment advisers. More than two thirds (68.2%) of these firms have 10 or fewer employees (5,110 reported having 1-5 employees and an additional 2,013 reported having 6-10 employees). *See Evolution/Revolution*, *supra* note 5.

[13] This has occurred due to the increased competition in execution services, primarily from the proliferation of electronic communications networks (ECNs) and other Internet-based entities that offer execution services at a fraction of traditional full-service brokerage costs. As commissions were squeezed – and as the number of investors and assets grew – many full service brokers diversified their products and services by offering on-line trading, asset-based fees, various advisory programs, and other additions to their traditional programs.

[14] As noted by the SEC in its 1999 proposal to expand the broker-dealer exception, "In addition to traditional commission-based brokerage, customers can now pay for securities transactions, related advice, and other services by paying a fee that is a fixed dollar amount…" *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 34-42099; IA-1845 at 6 (Nov. 4, 1999) ("*Proposal*"). "[S]ome broker-dealers offering these new [fee-based] accounts have heavily marketed them based on the advisory services provided rather than the execution services, which 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."

At the same time, demographic and economic trends have helped to create tremendous demand for investment advisory services. For example, the retirement and relative affluence of the baby boomers, combined with the trend away from defined benefit plans and the growth of defined contribution plans, has created growth in the number of individuals who seek assistance in managing their investments. The evidence indicates that these trends will continue in the foreseeable future and underscore the need to ensure that investors are appropriately educated on the differences among various investment services professionals and the standards and regulations that govern each. As demand has grown, numerous financial institutions are now competing to provide investment advisory services.

Globalization is also creating additional demand for investment advisory services. The growth in wealth in European and Asian markets -- and even emerging nations – will continue to make the investment advice business attractive and likely will contribute to further convergence. We have noted an increasing number of investment advisory firms that are extending their services beyond U.S. borders and are now competing with banks, insurance companies, and brokerage firms that provide investment advice.

Finally, we believe that advances in technology have facilitated the trend toward convergence. Technology continues to transform the manner in and the price at which financial services are delivered, greatly increasing competition among all service providers and introducing new waves of increasingly diverse financial products and services. With the assistance of technology, financial institutions – particularly larger firms with resources – have been able to enter new lines of business (including providing investment advice).

These and other developments present significant challenges to regulators. In general, it makes sense that entities that engage in essentially the same type of activities should be regulated in a similar fashion. As discussed below, these developments pose problems for a system of functional regulation as these entities – notably broker-dealers, banks, and hedge fund advisers – are acting as investment advisers without being subject to the regulations that would otherwise be applicable to them.

1.2.1 "Does the 'functional' regulatory framework under which banking, securities, insurance, and futures are primarily regulated by respective functional regulators lead to inefficiencies in the provision of financial services?"

The IAA believes that functional regulation offers the greatest investor protection and efficiencies in the provision of financial services. Unfortunately, with regard to advisory services, policymakers have failed to adopt a consistent functional approach. Given its importance to the investment advisory profession and to investor protection, we discuss this subject in some detail.

Id. at 16. *See also, Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers,* SEC Release Nos. IA-2340, 34-50980; File No. S7-25-99 at 7 (Jan. 6, 2005) (*Reproposal*).

The Advisers Act defines "investment adviser" as "any person who, for compensation, engages in the business of advising others, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[15] The Act, however, also sets forth several notable exceptions to the definition of investment adviser, as discussed below.

We believe the interests of investors and the regulated community are best served by a ***functional*** test that focuses on the nature of services provided. Consistent with functional regulation, the Advisers Act should govern investment advisory activities provided by ***any*** entity. If the service being offered bears the core characteristics of investment advisory services ***from the investor's perspective***, it should be subject to the same duties and obligations of an investment advisory service and an exception should not apply.

Broker-Dealer Exception

The Advisers Act provides an exception from the definition of investment adviser for "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[16]

As broker-dealers migrated toward asset-based fees and providing advisory services, they urged the SEC to adopt a rule to expand the scope of this exception by focusing 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.[17] Although we took exception to several provisions in the proposed rule, we agreed with the SEC that discretionary investment management cannot be deemed "solely incidental" to brokerage services and that a "functional test focusing on the nature of the services provided (rather than the form of the broker-dealer's compensation) is appropriate in determining whether and under what circumstances a brokerage account may be excluded from provisions of the Advisers Act."[18] We concurred with the SEC's conclusion that brokers and advisers "should be held to similar standards depending not on the statute under which they are registered, but upon the role they are playing."[19]

[15] Section 202(a)(11), Advisers Act.
[16] Section 202(a)(11)(B), Advisers Act.
[17] ***Proposal*** supra note 13. As noted in the proposed rule, broker-dealers had created services that involved the receipt of asset-based fees. Up until the proposed rule was released, receipt of such "special compensation" had meant that a broker-dealer could not claim the exception in the Advisers Act. The proposed rule would have allowed brokers to offer fee-based accounts to clients on a nondiscretionary basis as long as any investment advice provided was solely incidental to their brokerage services.
[18] Letter from David G. Tittsworth, Executive Director, ICAA, to Jonathan G. Katz, Secretary, SEC (Jan. 12, 2000) (hereinafter "Jan. 12, 2000 Letter"). While we agreed with the SEC that a functional test that focuses on the nature of services provided – rather than the form of the broker-dealer's compensation – is appropriate in determining whether a brokerage account falls within the Advisers Act, we expressed our view that the SEC's functional analysis did not go far enough.
[19] ***Reproposal***, ***supra*** note 14, at 36.

The SEC's rulemaking relating to the broker-dealer exception under the Advisers Act was invalidated by the D.C. Circuit Court of Appeals on March 30, 2007.[20] In response to the court's ruling, we, along with other groups, wrote the SEC noting that "[a] long-term response to the Court decision will require complex decisions about a variety of issues, including how best to draw a functional distinction between brokers and investment advisers, determining the appropriate standards to apply to the range of activities engaged in by investment service providers, how to educate investors to make informed choices among the various types of providers, and what disclosures are appropriate to inform investors of the differing roles of these providers and of the applicable legal protections."[21]

The SEC has recently proposed to reinstate certain interpretive provisions of its rulemaking relating to the broker-dealer exception under the Advisers Act.[22] These interpretive positions include clarification that discretionary investment management cannot be deemed "solely incidental" to brokerage services.[23] The IAA strongly supports reinstitution of this position and the restoration – albeit limited – of this aspect of functional regulation relating to the provision of advisory services by broker-dealers.[24]

Bank Exception

Banks and thrift institutions also enjoy an exception under the Advisers Act.[25] The basis for the IAA's consistent opposition to this exemption was summarized in a 1972 letter that we filed with the SEC, in which we stated that "*a firm which is organized and operates in the same manner as other registered investment advisory firms should be required to observe the same rules.*"[26]

If policymakers are truly concerned about appropriate and *functional* regulation of various entities in the financial services industry, we believe the banking exception in the Advisers Act should be amended to provide that banks that act as investment advisers are subject to the same laws and regulations governing other investment advisers. This concept was clearly and consistently articulated by former SEC Chairman Arthur Levitt during debate on financial services modernization legislation:

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[20] *Financial Planning Association v. S.E.C.*, 2007 WL 935733, C.A.D.C. (Mar. 30, 2007).
[21] *See* Letter from David G. Tittsworth, IAA, Consumer Federation of America, Financial Planning Association, Fund Democracy, National Association of Personal Financial Advisors, and North American Securities Administrators Association, to the Honorable Christopher Cox, Chairman (Apr. 24, 2007).
[22] *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, Rel. No. IA-2562 (Sept. 24, 2007).
[23] *Id.*
[24] *See* Letter from Karen L. Barr, General Counsel, IAA, to Nancy M Morris, Secretary, SEC (Nov. 30, 2007).
[25] Section 202(a)(11)(A), Advisers Act. On October 13, 2006, the Financial Services Regulatory Relief Act of 2006 was enacted exempting thrifts from the Advisers Act to the same extent as banks. Public Law No. 109-351.
[26] Letter from Ramsay D. Potts, Counsel, ICAA, to Ronald F. Hunt, Secretary, Securities and Exchange Commission (Oct. 6, 1972) (emphasis added). *See also* Letter from David G. Tittsworth, Executive Director, ICAA, to Harvey L. Pitt, Chairman, SEC (Dec. 27, 2001); Letter from David G. Tittsworth, Executive Director, ICAA, to Jonathan G. Katz, Secretary, SEC (July 9, 2004).

> *As the Commission has urged for more than a decade, a system of functional regulation would eliminate the inconsistencies between regulation of securities activities of banks and securities activities of Commission-regulated entities, providing enhanced investor protection….*
>
> *To assure adequate investor protection, the Commission believes that bank securities activities must be brought within the securities regulatory framework. Such an approach would ensure that the securities activities of all market participants – regardless of the structure in which they are conducted – would be subject to a single set of standards, consistently applied by one expert regulator.*[27]

As part of the Gramm-Leach-Bliley Act[28] enacted in 1999, Congress amended section 202(a)(11)(A) of the Advisers Act to provide that the term "investment adviser" includes a bank or bank holding company that "serves or acts as an investment adviser to a registered investment company. . ."[29] While the IAA believes this provision was a step forward in attaining appropriate functional regulation, it begs the question of why banks that act as an investment adviser in other cases should not also be subject to the protections and regulations of the Advisers Act.

Hedge fund adviser exception

Hedge funds offer a number of potential benefits to eligible investors by providing an alternative investment strategy that may reduce portfolio risk, increase investment returns during difficult market or economic conditions, and allow for participation in non-traditional products and markets. Because firms offering investments in hedge funds are providing investment advice, we supported the SEC hedge fund adviser registration rule[30] -- subsequently vacated by the D.C. Circuit Court of Appeals[31] -- that would have sharply curtailed hedge fund advisers' ability to avail themselves of the "private adviser" exemption from SEC registration under the Advisers Act. Consistent with our support of functional regulation, and despite the court decision vacating the rule, the IAA continues to support the registration of hedge fund advisers.

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

[28] Public Law No. 106-102.

[29] Section 217, Gramm-Leach-Bliley Act. Section 217 also provides that, in the case of a bank, if the advisory services are provided through a "separately identifiable department or division," such department or division, and not the bank itself, shall be deemed to be the investment adviser.

[30] ***See*** Letter from David G. Tittsworth and Caroline Schaefer, Investment Counsel Association of America, to Jonathan B. Katz, Secretary (Sept. 14, 2004); ***see also*** Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan B. Katz, Secretary (July 7, 2003) in support of ***Registration Under the Advisers Act of Certain Hedge Fund Advisers***; Rel. No. IA-2266; File No. S7-30-04 (Dec. 4, 2004) ("SEC hedge fund rule").

[31] ***Goldstein v. SEC***, 451 F.3d 873 (D.C. Cir. 2006) (vacating and remanding SEC hedge fund rule).

1.2.2 "Does the 'functional' regulatory framework pose difficulties for considering overall risk to the financial system? If so, what extent have these difficulties been resolved through regulatory oversight at the holding company level?"

Effective coordination is critical to the success of functional regulation. Accordingly, regulators must coordinate both their policy and enforcement efforts to address the complex challenges posed by those entities engaged in broad array of financial activities and services. In this regard, alternative regulatory structures and models of collaboration should be considered that would facilitate a more coordinated and coherent approach to the overall risk to the financial system.

1.2.3 "Many countries have moved towards creating a single financial market regulator (e.g., United Kingdom's Financial Services Authority; Japan's Financial Services Agency; and Germany's Federal Financial Supervisory Authority (BaFin)). Some countries (e.g., Australia and the Netherlands) have adopted a twin peaks model of regulation, separating prudential safety and soundness regulation and conduct-of-business regulation. What are the strengths and weaknesses of these structural approaches and their applicability in the United States? What ideas can be gleaned from these structures that would improve U.S. capital market competitiveness?"

The IAA recognizes the attraction of a single regulator model. It may appear to be an appropriate means of addressing the complexity of the U.S. regulatory structure and facilitating a more coherent, principles-based approach that could enhance investor protection and provide greater clarity and consistency for the regulated parties. For these reasons, the Department may wish to study the example offered by the U.K., as well as the dual regulator approach adopted by Australia and the Netherlands, to ascertain the effectiveness of this approach. However, we must note that coordination remains critical even with a single regulator as separate departments are required to address the widely varied and distinct functional regulatory issues presented by the array of products and services offered by the financial services industries

While we endorse the concept of a single regulator for investment advisers, we also recognize that there are enormous political and jurisdictional hurdles that would have to be negotiated to achieve a single regulator for all U.S. financial institutions (much less a single global regulator). In addition, we are not convinced that a single regulatory body would provide for improved – or more efficient – regulation of the investment advisory profession. Despite various concerns we have regarding our current regulatory requirements, on balance we believe the SEC's administration of the Advisers Act – and its reliance on disclosure and broad anti-fraud authority rather than specific and rigid regulatory requirements – remains the appropriate regulatory scheme for the investment advisory profession.

Given the significant political impediments, as well as doubts as to whether a single regulator for all financial institutions would truly achieve greater investor protection for investment advisory clients, we question whether the Department should expend a great deal of time and effort in this area. Instead, we respectfully suggest that the Department focus on issues (such as functional regulation) that present significant problems for investors and that have a greater likelihood of being addressed.

1.3 "What should be the key objectives of financial institution regulation? How could the framework for the regulation of financial institutions be more closely aligned with the objectives of regulation? Can our current regulatory framework be improved, especially in terms of imparting greater market discipline and providing a more cohesive look at overall financial system risk? If so, how can it be improved to achieve these goals?"

The IAA agrees with the Department that the framework for regulation must be closely aligned with agreed-upon regulatory objectives. We believe the key objectives should be investor and consumer protection, management of systemic financial risk, and the efficient operation of the capital markets.

1.3.4 "In recent years, debate has emerged about 'more efficient' regulation and the possibility of adopting a 'principles-based' approach to regulation, rather than a 'rules-based' approach. Others suggest that a proper balance between the two is essential. What are the strengths, weaknesses and feasibility of such approaches, and could a more 'principles-based' approach improve U.S. competitiveness?"[32]

Under a principles-based approach, policymakers develop a core set of high-level principles to guide proper behavior by the regulated parties. Ideally, these principles are flexible enough to adapt to developments in the market. However, a balance must be struck since an effective principle-based approach must also provide sufficient guidance for compliance by firms. This principles-based approach stands in contrast to highly prescriptive and detailed rules-based regulation that often imposes excessive regulatory costs without a commensurate enhancement of investor protection. Although we address certain problems with investment adviser regulation in this comment, the IAA believes that the Advisers Act merits study as an example of balanced principles-based regulation.

Principles-Based Regulation: The Advisers Act

The Advisers Act was the last in a series of federal laws designed to eliminate certain abuses in the securities industry found to have contributed to the stock market crash of 1929 and the depression of the 1930's. Its basic statutory framework is relatively simple and straightforward. Certain investment advisers are required to register with the SEC and are subject to regulations issued and enforced by the SEC.[33] The statute makes it unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client or prospective client," to engage in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and to engage in principal trades without receiving the consent of the client.[34]

[32] The IAA takes no position at this time on the issues discussed in Sections 1.3.1, 1.3.2 or 1.3.3.
[33] *See* Sections 203 and 209, Advisers Act.
[34] Section 206(1), (2), and (3), Advisers Act.

The law authorizes the SEC to promulgate rules and regulations that define and prescribe ways to prevent any act, practice, or course of business by an adviser that is "fraudulent, deceptive, or manipulative."[35] Consistent with the other major federal securities laws, the Advisers Act largely relies on full and fair disclosure to effectuate its purposes.

As part of this regulatory scheme, investment advisers are subject to a strict fiduciary duty. This duty has been upheld by the U.S. Supreme Court[36] and reiterated by the SEC in various pronouncements over the years.[37] This fiduciary duty is one of the primary distinctions between investment advisers and others in the financial services industry.[38] As a fiduciary, "an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions."[39] Among obligations that flow from an adviser's fiduciary duty are: (1) the duty at all times to place the interests of clients first; (2) the duty to have a reasonable basis for its investment advice; (3) the duty to seek best execution for client securities transactions where the adviser directs such transactions: (4) the duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines, and restrictions; (5) the duty to treat clients fairly; (6) the duty to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest; and (7) the duty to respect the confidentiality of client information.[40]

We believe the principles-based structure of the Advisers Act – and its reliance on disclosure and broad anti-fraud authority rather than specific and rigid regulatory requirements – is both appropriate and effective. We also recognize, however, that all regulatory frameworks have some mix of principles-based and rules-based regulation and that the actual implementation of any regulatory structure is critical in determining whether it is efficient and effective.

Concern About Increasing "Rules-Based" Regulation

Legal, regulatory, and compliance requirements for investment adviser firms have increased dramatically over the last several years. Many of these new requirements have substituted rules-based, "command-and-control" regulation in practice for pre-existing principles-based regulation. For example, in December 2003, the SEC adopted Rule 206(4)-7 that requires an adviser to maintain written, comprehensive compliance programs. Specifically, the compliance program rule requires an adviser to: (1) adopt and implement policies and procedures reasonably designed to prevent violations of the

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[35] Section 206(4), Advisers Act. The SEC also is given authority to exempt persons or transactions from the Advisers Act or regulations thereunder, "to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." Section 206A, Advisers Act.
[36] ***Capital Gains**, **supra*** note 3, at 186.
[37] ***See, e.g., In re: Arleen W. Hughes***, Exchange Act Release No. 4048 (Feb. 18, 1948).
[38] Paul F. Roye, Director, Division of Investment Management, SEC, Remarks before the ICAA: 2000 and Beyond: SEC Priorities for the Investment Advisor Profession (Apr. 6, 2000).
[39] Lemke & Lins, ***Regulation of Investment Advisers***, at 2-34 (2007).
[40] ***See*** IAA Standards of Practice.

Advisers Act; (2) review the policies and procedures at least annually to determine their adequacy and effectiveness of their implementation; and (3) designate a chief compliance officer responsible for administering the policies and procedures.[41] Additionally, in July 2004, the SEC adopted a new rule under Section 204 of the Advisers Act that requires all registered investment advisers to adopt codes of ethics. The codes of ethics must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel. The rule and rule amendments are intended to promote compliance with fiduciary standards by advisers and their personnel.[42]

Although ostensibly principles-based and flexible regulation, in practice and implementation these rules have assumed characteristics typically associated with rules-based, command-and-control regulation as the SEC staff articulates its specific expectations regarding compliance with the rules. This is particularly evident with regard to deficiency letters issued by the SEC Office of Compliance Inspections and Examination (OCIE). These letters are an important tool in the inspection process and serve as a primary method of protecting investors, by identifying significant conflicts of interest, frauds, and manipulation, as well as by helping advisers strengthen their compliance programs. However, in many instances, these letters have been used as a means to require firms to adopt practices that are not clearly based on previously articulated rules and regulations.

Similarly, as referenced above, routine SEC inspections often commence with a 27-page letter requesting numerous documents, some of which are not required to be maintained under the relevant record-keeping rules. Sometimes, the letter requests an adviser to *create* documents for purposes of the examination that it ordinarily does not use for business purposes. This process in effect imposes new specific recordkeeping rules on advisers without the benefit of a notice-and-comment rulemaking process and has significantly increased regulatory costs for advisers in recent years.

Investment advisers have a compelling and legitimate need to be notified and to understand the applicable rules *before* SEC staff proceeds to require compliance with any new requirements. Because new regulatory policies should not be set by inspection activities, the SEC must endeavor to communicate legal requirements and standards to investment advisers separately from the examination process, preferably after a process that includes appropriate notice and opportunity to comment.[43]

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[41] *Supra* note 10.
[42] 17 C.F.R. § 275.204A-1.
[43] We also encourage the efforts of the SEC Division of Investment Management -- the division of the SEC responsible for regulating investment advisers -- and OCIE to improve their communication and coordination as there have been frequent occasions where deficiency letters issued by OCIE have misinterpreted the law, Division policy, or incorrectly implied that certain suggested practices are requirements. Given the present structure of the SEC, it is essential that OCIE work more closely with the Division of Investment Management to ascertain the Division staff's position on such policy matters and to apply them consistently.

1.3.5 "Would the U.S. financial regulatory structure benefit if there was a uniform set of basic principles of regulation that were agreed upon and adopted by each financial services regulator?"

It may be beneficial for regulators and representatives of the financial services industries, investors and consumers, and other market participants to join together in an effort to develop mutually agreed-upon "guiding" principles for financial services regulation. These high-level principles could result in more balanced, consistent and predicable outcomes that would facilitate industry compliance and enhance investor protection. As we noted earlier in this letter, increased interagency communication and joint regulatory efforts can increase regulatory consistency.

1.4 "Does the current regulatory structure adequately address consumer or investor protection issues? If not, how could we improve our current regulatory structure to address these issues?"

Investor protection must remain the touchstone for regulation of financial services. The IAA believes that the current regulatory structure for investment advisers under the Advisers Act appropriately addresses investor protection. As discussed above, investment advisers are subject to a strict fiduciary duty that requires that they act at all times act in their clients' best interests.[44] This standard promotes the highest level of investor protection.

The IAA believes that a report to be delivered to the SEC later this month could have significant ramifications for consumer protection under the Advisers Act and may merit examination by the Department. In conjunction with the broker-dealer rulemaking discussed above, the SEC called for a study to compare the "levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act" and to "recommend ways to address any investor protection concerns arising from material differences between the two regulatory regimes."[45] SEC Chairman Cox has announced that the results of this study – being conducted by the RAND Corporation -- will be delivered to the SEC no later than December 2007 and that he expects it to provide an "important empirical foundation for considering improvements" in this regulatory area.[46]

We also believe that the SEC can and should play a much more proactive role in educating investors and consumers about fundamental investor protection issues.[47] The SEC's Office of Investor Education and Advocacy, for example, should take a leading role in developing and providing educational information to the public about investments and the various types of persons and entities that provide advice about investments. As

[44] *Supra*, notes 37-41.

[45] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Rel. Nos. IA-2376; 34-51523; File No. S7-25-99 at 68 (Apr. 12, 2005).

[46] S*ee* Press Release, "Commission Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts," Rel. No. 2007-95 (May 14, 2007).

[47] *See* Letter from David G. Tittsworth, Executive Director, IAA, to the Honorable William H. Donaldson, Chairman, SEC (June 22, 2005).

the SEC's own focus groups have revealed, investors are "generally confused about the distinctions between brokers, financial advisors/consultants, investment advisers and financial planners."[48] Accordingly, we believe that the SEC must better inform investors and the public about the differences between brokerage and advisory activities, the laws and regulations governing each, and specific issues raised by its rulemakings. We strongly believe the SEC must play a central role in educating the investing public about these important issues.[49]

1.5 "What role should the States have in the regulation of financial institutions? Is there a difference in the appropriate role of the States depending on financial system protection or consumer and investor protection aspects of regulation?"

Congress addressed some of the problems associated with the dual system of state and federal regulation in the U.S. when it passed NSMIA.[50] As applied to the investment advisory profession, NSMIA divided regulatory responsibility between the SEC and the states by prohibiting an investment adviser from registering with the SEC unless it has more than $25 million in assets under management, is an adviser to a registered investment company, or fits one of the limited exemptions.[51] One of the Act's principal purposes was to leverage state and federal resources by "eliminating overlapping regulatory responsibilities."[52] This legislative intent was well summarized in the SEC's proposed rules to implement the law:

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

[48] *Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosure,* SEC (Mar. 10, 2005) at 8.
[49] Last year, the IAA worked with the Coalition on Investor Education -- comprised of Consumer Federation of America, North American Securities Administrators Association, Investment Adviser Association, Financial Planning Association, and CFA Institute – to publish an investor education brochure called "Cutting through the Confusion." After a meeting with the SEC's Office of Investor Education in October 2006, various links to the brochure were included on the SEC's web site. Linking the brochure on the web site was a positive first step in educating investors. Unfortunately, the links to this investor education piece have recently been removed. Reinstating references to the educational brochure would assist in providing helpful information to investors about issues they confront when engaging the services of an investment professional.
[50] *Supra* note 4.
[51] The $25 million threshold was intended to provide a bright line test for allocating regulatory responsibility of advisers between the SEC and the states, representing a rough cut between advisers that generally do business in interstate commerce and those that generally have more localized practices. The report accompanying the Senate-passed bill notes that the SEC "may also use its exemptive authority under the bill to raise the $25 million threshold higher as it deems appropriate in keeping with the purposes of the Investment Advisers Act" and concurred in a recommendation of NASAA to review the appropriateness of this threshold at least every three years. S.Rpt. 104-293, p. 5 (June 26, 1996).
[52] S.Rpt.104-293, pp. 3-4 (June 26, 1996).

regulatory resources of the Commission and the states could be put to better, more efficient use.[53]

NSMIA's allocation of regulatory responsibility between the SEC and the states is working well. It enhances investor protection, provides for more efficient use of limited regulatory resources, and reduces burdensome and unnecessary regulatory costs.[54]

1.6 Europe is putting in place a more integrated single financial market under its Financial Services Action Plan. Many Asian countries as well are developing their financial markets. Often, these countries or regions are doing so on the basis of widely adopted international regulatory standards. Global businesses often cite concerns about the costs associated with meeting diverse regulatory standards in the numerous countries in which they operate. To address these issues, some call for greater global regulatory convergence and others call for mutual recognition. To what extent should the design of regulatory initiatives in the United States be informed by the competitiveness of U.S. institutions and markets in the global marketplace? Would the U.S. economy and capital market competitiveness be better served by pursuing greater global regulatory convergence?"

Globalization is transforming the financial services industry. Accordingly, it is critical that regulators in key financial centers worldwide come together in an attempt to coordinate both their policy and enforcement efforts to address the complex challenges posed by financial entities with international activities. The IAA believes that market competitiveness would be better served by pursuing greater global regulatory convergence and that principles-based regulation is fundamental to meeting this challenge.

Given the increasing globalization of the asset management industry, we cannot overstate the need for consistency with respect to the regulatory frameworks for investment advisers in the U.S., Canada, the U.K., and the European Union. Many investment advisers are subject to regulation in each jurisdiction and their inconsistent and potentially conflicting regulatory standards. It is increasingly difficult, time-consuming, and expensive for advisers to address the compliance requirements of disparate regulatory regimes. The IAA has long stressed that securities regulators should work together to encourage uniformity in the approach to rules relating to investment advisers with operations in multiple jurisdictions so they can better operate under consistent regulatory frameworks.[55] Coordination by the various regulatory authorities is

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

[54] There are, however, areas not covered by NSMIA where advisers continue to be subject to an unnecessarily burdensome and costly patchwork of state regulations. For example, more than thirty states have enacted consumer data-related breach notice laws that have made it necessary for advisers to track and analyze varying state laws based upon the location(s) of their clients.

[55] *See, e.g.*, Letter from Paul D. Glenn, Counsel, IAA, to Ontario Securities Commission and Authorité des marchés financiers (June 20, 2007); Letter from Monique S. Botkin, Counsel, IAA, to Christopher Preston, Financial Services Authority (Dec. 6, 2006).

critical to facilitating compliance with their rules and encouraging growth of the investment advisory industry.[56]

Adoption of a principles-based approach facilitates cross-border recognition of other countries' regulatory regimes and the development of common approaches through harmonization. In this regard, we applaud SEC Chairman Cox's recent statements emphasizing the need for global regulators to harmonize, recognize and standardize their home country regulations.[57]

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The IAA appreciates the Department's consideration of our comments. We would be pleased to provide any additional information the Department may require regarding these important issues.

Respectfully submitted,

David G. Tittsworth
Executive Director

Neil A. Simon
Vice President for Government Relations

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[56] We note that the SEC, in response to commentators identifying the U.K.'s current regulatory regime for commission-sharing arrangements and the industry practices prevalent in the U.S., revised its interpretation of the statutory safe harbor to permit the industry to structure flexible arrangements that are consistent with the U.S. statute and that best serve investors. ***See*** SEC Release No. 34-54165, ***Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act*** (July 18, 2006) at 52.

[57] ***Learning from Shogun – Toward IOSCO's Vision of a Global Market***, Speech delivered by SEC Chairman Christopher Cox before the IOSCO Technical Committee Conference, Tokyo, Japan, (Nov. 8, 2007).