STATEMENT OF MATTHEW P. FINK

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES SENATE

ON

PROPOSALS TO INCREASE SUPERVISION OF INVESTMENT ADVISERS

FEBRUARY 20, 1992

SUMMARY AND TABLE OF CONTENTS

I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, which represents investment advisers to over 3,400 mutual funds and a wide variety of other clients, including retirement plans, charitable organizations, corporations and individuals. A substantial portion of the total assets managed by all Securities and Exchange Commission ("SEC") registered advisers are managed by these Institute members. The Institute is unique in that it represents all types of investment advisers, including investment counseling firms, financial planners and investment management affiliates of securities firms, banks and insurance companies.

We are pleased to be here today to express our views on various proposals to increase supervision of investment advisers. The Institute has been a participant from the outset in the ongoing debate on how to improve regulation of the investment advisory industry. In this respect, we have always supported strong and appropriate regulation for investment advisers. We start with the premise that in the area of financial products and services, stringent regulation is imperative for sound investor protection and efficient securities markets. In our view, the existing regulatory scheme proscribed under the Investment Advisers Act of 1940 (the "Advisers Act" or the "Act") is generally adequate. The principal problems facing investors, the industry and the regulators today stem primarily from the SEC's lack of resources to enforce the Act and the rules thereunder.

II. BACKGROUND

A. Investment Advisers Should Be Inspected More Frequently

The investment adviser industry has grown at an exponential pace in recent years. Chairman Breeden recently estimated that, "in the past 10 years, assets managed by advisers have grown tenfold and the number of advisers has grown three to four times."[1] Yet, the number of SEC field inspectors responsible for investment adviser inspections has remained relatively constant since 1981, at a level of less than one inspector per state.[2] The current average inspection cycle is approximately 30 years.[3] Considering the high failure rate of small businesses, it is likely that some advisers are never inspected during the life of

---

1 See The SEC Proposes Tightening Reins on 17,000 Advisers, The Wall Street Journal, January 24, 1992.

2 See United States General Accounting Office Report to Congressional Requestors, "Investment Advisers: Current Level of Oversight Puts Investors at Risk" (June 1990), p. 10. Members of Congress have requested that this report be updated as soon as possible, but not later than May 1992. See Letter from U.S. Representatives John D. Dingell, Edward J. Markey, Dennis Eckart and Rick Boucher to The Honorable Charles A. Bowsher, Comptroller General, General Accounting Office, dated January 6, 1992.

3 See U.S. Securities and Exchange Commission, "In Brief, Budget Estimate Fiscal 1993," (January 1992).

their business. As a consequence of the SEC's limited resources, the industry has not been subject to adequate oversight. We believe that increased funding would allow the SEC to better enforce existing laws and regulations and thereby increase investor protection. We note that the report prepared by the General Accounting Office in 1990 on investment advisers reached the same conclusion.[4]

In contrast to the current inspection cycle of investment advisers, inspections of other registrants under the federal securities laws are done on a much more frequent basis. For example, mutual funds are subject to an average inspection cycle of 18 months.[5] In fact, the SEC's goal is to inspect annually money market mutual funds, whose assets comprise almost one-half of all mutual funds.[6] Thus, the Institute's concerns focus only on the inadequacy of investment adviser inspections.

B. Past Initiatives Have Failed

Alternative proposals to improve investment adviser

---

[4] See supra note 2, at 35-37.

[5] See Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Concerning Appropriations for Fiscal Year 1992, Hearings Before the Subcomm. on Commerce, Justice and State, The Judiciary, and Related Agencies of the Senate Comm. on Appropriations (February 22, 1991).

[6] See supra note 3.

regulation have been suggested over the past few years, but have failed to gain consensus because the industry is so diverse, the problems multi-faceted and the solutions elusive. Specifically, legislative proposals have included a wide range of proposals, such as a holding out provision to require registration of financial planners, a private right of action under the Advisers Act, and Congressionally mandated disclosure items. Also considered were proposals to establish an investment adviser self-regulatory organization[7] and to expand the small adviser exemption under the Act[8]. The Institute supported the objectives of these proposals, which were to increase investor protection, but expressed specific concerns about certain aspects of them.

Proposals such as these appear to have been proffered as alternative solutions to the real problem, which is the SEC's lack of sufficient resources. Therefore, we strongly agree with the view expressed in your recent letter to Chairman Breeden that a proposal focusing on increasing the SEC's resources is more likely to succeed than proposals to amend significantly the regulatory scheme, and therefore will achieve the ultimate goal of increasing investor protection.[9]

---

[7] See S. 1410, "Investment Adviser Self-Regulation", 101st Cong., 1st Sess. (1989).

[8] See Investment Advisers Act Release No. 1140, dated September 16, 1988.

[9] See Letter from U.S. Senator Christopher J. Dodd to The Honorable Richard C. Breeden, dated February 6, 1992.

III. SEC RESOURCES SHOULD BE INCREASED THROUGH AN ANNUAL INVESTMENT ADVISER FEE

Consistent with our historical support of increasing SEC resources to insure that inspections are performed on a regular basis, the Institute urges Congressional enactment of an annual investment adviser fee dedicated to fund investment adviser inspections.[10] We believe that active oversight of the industry will serve to enhance investor protection. Concomitantly, public confidence, which is the cornerstone of the advisory industry, will be strengthened.

The Institute has the following comments on how the annual fee should be determined.

A. The Fee Should Be Based On Assets Under Management

First, we recommend that the fee be based on an investment adviser's assets under management, rather than a flat fee. This approach would be more equitable, especially taking into consideration the large number of smaller advisers that are registered with the SEC. In order for the SEC to raise sufficient revenue, a flat fee would likely be disproportionately

---

10 Currently, investment advisers are required to pay to the SEC a registration fee of $150 upon the filing of a Form ADV (*see* Rule 203-3 under the Act).

large for small advisers. (However, where an adviser does not have assets under management, such as a financial planner, we suggest that a minimum, flat fee be imposed.)

B. An Annual Fee Schedule With Reasonable Breakpoints Should Be Adopted

Second, we recommend that the assessment be made pursuant to a fee schedule with reasonable breakpoints, as opposed to an across the board fee based on a percentage of an adviser's assets under management. A fee schedule with breakpoints would ensure that the costs being borne by individual members of the industry are commensurate with the costs of operating the SEC inspection program. In this respect, there would be no justification for imposing upon an investment adviser that is 100 times larger than a smaller adviser a fee that is 100 times greater, since the SEC presumably would not expend 100 times its resources in overseeing the larger adviser.

We are aware that some concern has been expressed about the future viability of breakpoints. While we understand the concern, we are wary about the seemingly available solutions for addressing it. Specifically, one common way to remedy this problem would be to index the breakpoints for inflation. However, we would oppose this approach because it would bring with it a new set of problems. For example, the level of assets managed by investment advisers could decline in times of high inflation, which would mean that advisers would be paying more in fees even though their assets have decreased. We hope to continue working with you on this issue.

C. Investment Company Assets Should Be Excluded From The Fee Calculation

Third, the assets of investment company clients should be excluded from an investment adviser's assets under management for purposes of determining the fee. Investment companies already pay considerable fees to the SEC under the Investment Company Act of 1940 and the Securities Act of 1933. As a result, the investment company industry is subject to rigorous oversight under the Investment Company Act and the rules thereunder. Consequently, this portion of an adviser's business is already subject to substantial fees and adequate oversight.

D. The Fee Should Be Dedicated To Funding Investment Adviser Inspections

Fourth, the revenue collected by the SEC from the assessment of this fee should be dedicated to overseeing the investment advisory industry. The industry is opposed to a fee that potentially could be allocated for some other SEC function or as an offsetting receipt going into the general Treasury. To ensure that the fees assessed on the industry continue to be used solely for the purposes for which they are intended, i.e., enhancing the SEC's oversight of the investment advisory industry, we ask that the fee schedule be subject to Congressional oversight.

IV. THE INSPECTION PROGRAM SHOULD BE FOCUSED ON HIGH RISK INVESTMENT ADVISERS

The Institute strongly urges the SEC to focus its investment adviser inspection program on all high risk advisers, regardless of their size. As the SEC recognizes, some investment advisers have a higher risk profile than others.[11] Factors that could be considered in making this determination include whether an adviser has custody, the types of clients (e.g., small retail investors versus large sophisticated institutions), whether the adviser is subject to other schemes of SEC regulation (e.g., the Investment Company Act or the Securities Exchange Act of 1934), the level of resources available to allocate toward internal compliance procedures, and prior regulatory violations.

Thus, high risk advisers may vary significantly in size from a one person firm to a multi-billion dollar company. Therefore, we do not believe that a mechanistic approach of simply targeting by size is the most effective means of enforcement. In fact, larger investment advisers may tend to have a lower risk profile than smaller advisers since they have greater resources to allocate to compliance procedures (including employing full-time compliance personnel). In addition, large

---

[11] In the President's SEC budget request for 1993, it is stated that, "In order to maximize the impact of investment adviser inspections, investment advisers managing more than $1 billion or having high risk profiles will be targeted for inspection in 1993." See supra note 3.

advisers are more likely to be part of an entity that engages in a variety of securities related activities (such as managing an investment company, acting as a broker-dealer), which are subject to a panoply of federal securities regulations with stringent internal compliance procedures and controls. As a result, these entities generally adopt such procedures with respect to <u>all</u> facets of their operations, even where not required by law. We submit that the criteria for establishing the focus of the inspection program should not be size of the investment adviser, be it large or small, but the level of risk .

V. <u>THE SEC CAN UPDATE THE ACT THROUGH RULEMAKING</u>

The Advisers Act provides an adequate framework for regulating the investment adviser industry and thereby protecting the investing public. The SEC has, over the past fifty years, been able to update the Act to respond to changes in the industry through its rulemaking authority. There are instances where it is more advisable for the SEC to pursue changes through the rulemaking process than for Congress to do so through legislation, particularly where the changes are technical and need detailed consideration. There are four such regulatory changes that the Institute recommends be considered at this time.

A. Conflicts Of Interest

First, the information required in the Form ADV concerning potential conflicts of interest should be required to be prominently disclosed in the front of the Form. We concur with the concerns expressed by the Director of the Division of Investment Management that investors are not adequately informed about these issues.[12] Of particular concern is the situation where an adviser receives compensation upon the sale of a product he recommends. In contrast to a person who goes into an XYZ investment center and understands that the investment advice he receives may be biased because the sales person is being compensated by XYZ, there usually is no way for an investor to know that an adviser will receive a commission upon the sale of the product that he is recommending. We are pleased that the Division of Investment Management apparently has begun working on a proposal to amend Form ADV to require more prominent disclosure when an adviser receives commission-based fees.[13]

B. Suitability Determinations

Second, consideration should be given to regulatory action clarifying an adviser's fiduciary duty under the Advisers Act.

---

12 See SEC Presses Issue of Fee Disclosure, Financial Planning, January 1992.

13 Id.

While it is a fundamental element of the Act that an investment adviser owes his client a fiduciary duty, the various elements of this duty are not spelled out in the Act. One significant element of this duty that should be either the subject of a rulemaking proposal or, at the very least, addressed by the SEC in an interpretive release is an adviser's duty to ensure that its investment advice is suitable to the client's objectives, needs and circumstances. An explicit reminder to the industry of the fiduciary duty owed to clients, especially the duty to make a suitability determination, will further increase investor protection.

C. <u>Fidelity Bonding</u>

Third, consideration should be given to requiring investment advisers who have custody of client assets to maintain a bond to protect investors against larceny, embezzlement and other fraudulent acts (i.e., a fidelity bond). Clients whose securities and monies can be reached by an adviser are exposed to additional risk. While we believe that custody should continue to be permitted and that the requirements governing custodial arrangements included in Rule 206(4)-2 of the Act are sufficient, we recommend that a fidelity bond be required to provide a source of reimbursement for investors defrauded by such advisers.

D. Additional Internal Compliance Procedures

Fourth, consideration should be given to requiring additional internal compliance procedures. It is difficult to craft precisely requirements that would be applicable to all advisers given the unusual diversity that exists in the industry. However, general requirements could be adopted such as requiring advisers to adopt written supervisory procedures.

* * *

The Institute is hopeful that these changes could be accomplished through the SEC rulemaking process. However, if it is determined otherwise, the Institute would support legislation implementing these changes provided it does not delay enactment of legislation providing for an annual fee.

VI. CONCLUSION

In conclusion, the Institute strongly supports increasing SEC resources to improve its oversight of the investment adviser industry. Allowing the SEC to raise sufficient revenue to improve its investment adviser inspection program will greatly enhance investor protection. We are pleased that a proposal under consideration targets increased SEC resources to improve its investment adviser inspection program. Crafting such a proposal in this way will avoid the legislative stalemates encountered in past years. Over the last several years, proposals to modify extensively investment adviser regulation have failed to gain industry consensus because of the significant diversity in the industry, the multi-faceted nature of the problems and the elusiveness of the solutions.

Specifically, the Institute supports the assessment of an annual investment adviser fee, so long as (1) the fee is based on assets under management pursuant to a schedule with reasonable breakpoints, (2) investment company assets are excluded from the calculation of the fee, and (3) the fees are used solely to defray the SEC's costs in overseeing the investment advisory industry and they are subject to Congressional oversight.

The Institute strongly recommends that the focus of the SEC inspection program target <u>all</u> high risk profile investment advisers, rather than applying a mechanistic approach based on size.

The Institute supports various SEC rulemaking initiatives under the Advisers Act to (1) enhance the disclosure requirements, (2) prohibit advisers from making unsuitable recommendations to clients, (3) require a fidelity bond, and (4) improve internal controls. If these changes cannot be accomplished through the rulemaking process, we would support appropriate legislation provided it does not impede the enactment of legislation providing for an annual fee, which we respectfully recommend be the legislative priority.