Statement of

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On Behalf of

The Investment Counsel

Association of America

Before the

Senate Subcommittee on Securities

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The ICAA is a national professional association of more than 160 investment advisory firms that collectively manage client assets in excess of $410 billion. Founded in 1937, the ICAA played an active role in assisting Congress to develop and enact the Investment Advisers Act of 1940 (Advisers Act). All ICAA member firms are entitled to represent themselves as "investment counsel" under section 208(c) of the Advisers Act. As such, ICAA members occupy a unique niche within the investment adviser universe. Our firms are primarily in the personalized investment management business. Unlike many other investment advisers, our members sell only investment advice and investment management services to clients. ICAA members do not participate in any commissions or profits from investment transactions recommended to clients. We are not compensated according to the volume of transactions as to which we provide investment advice nor do our firms generally have custody of any client funds. Rather, ICAA members are compensated solely on the basis of negotiated fees for investment services rendered (primarily based on a percentage of assets under management).

II. CURRENT LAWS AND REGULATIONS

Since its inception, the ICAA has supported appropriate federal regulation of its member firms and of the investment advisory industry. The ICAA maintains that appropriate regulation, registration, enforcement, full and fair disclosure, and adherence to high ethical standards of conduct will preserve and enhance the trust and confidence of our members' clients. We believe the Advisers Act has provided a workable framework for the investment adviser industry:

1. Advisers are required, by statute, to comply with all aspects of the Advisers Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Commodity Exchange Act, the rules of the Municipal Securities Rulemaking Board, and the rules and regulations of the SEC issued under the Advisers Act.

2. Advisers are subject to a broad range of civil and criminal penalties for failure to comply with the mandates of the Advisers Act and regulations issued thereunder, including the new penalties and enforcement actions enacted in 1990.

3. Congress has given the SEC a broad grant of rulemaking and enforcement authority to mandate registration, disclosure, informational, contractual, financial, and other requirements upon advisers, as well as to issue any rules, regulations, and orders "as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission." Over the years, the SEC has exercised the full range of its statutory authorities by issuing extensive and varied regulations dealing with all aspects of our business practices.

In sum, we believe the Advisers Act has all of the requisite elements to carry out the goals of the law -- to protect the public interest and investors. What is lacking to address concerns that have been raised by Chairman Dodd and others is not additional laws or regulations, but rather the resources required to enable the SEC adequately to carry out the enforcement and regulation responsibilities already required under the law.

III. LEGISLATIVE PROPOSALS

A. **FEES:** For many years, the ICAA generally has supported legislation to allow the SEC to impose and collect periodic fees for registered investment advisers in order to enhance the SEC's ability to perform inspections of the investment advisory industry and to carry out its enforcement and regulation responsibilities under the Advisers Act. As has been pointed out in hearings of this Subcommittee, current inspection of advisers is inadequate. The ICAA supports the concept of requiring annual fees for all advisers, provided that such fees are reasonable and are dedicated solely for use by the SEC in undertaking its inspection and enforcement responsibilities under the law.

B. **SUITABILITY REQUIREMENT:** The ICAA supports the concept of prohibiting advisers from making unsuitable recommendations to their clients. Current regulatory requirements -- as well as ICAA standards -- already embrace this aspect of an adviser's fiduciary duty to clients. While we question the need for restating existing law and regulatory interpretations, we of course will continue to adhere to the basic premise of requiring advisers to make suitable recommendations for their clients.

C. **BONDING:** The need for further statutory authority to enable the SEC to require bonding for advisers who have custody of client funds clearly is driven by the desire to provide a recovery to clients who are injured as a result of an adviser's embezzlement or larceny of such funds. While the ICAA supports the basic intent of such authority, we strongly believe that any such authority should recognize and appreciate the difference between an adviser's **actual** custody of client funds or securities on the one hand, and, on the other, an adviser's ability to exercise **discretionary** authority over client funds held by an already-bonded third party. In the former situation, the need for bonding of the adviser is justified to protect the client from larceny and embezzlement by the adviser. In the latter situation, however, bonding of the adviser may be duplicative, unnecessary, and costly. We understand the unfortunate situations that have led to this type of proposal and would be pleased to work with this Subcommittee and the SEC to try and address the needs of investors for additional protection against criminal actions by advisers who have actual custody of client funds or securities.

STATEMENT OF

DAVID S. LEE

ON BEHALF OF

THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

BEFORE THE

SENATE SUBCOMMITTEE ON SECURITIES

FEBRUARY 20, 1992

Chairman Dodd, Senator Gramm, and Members of the Subcommittee, my name is David S. Lee. I am a Managing Director of Scudder, Stevens & Clark, Inc, an investment counsel firm founded in 1919 that manages total client assets in excess of $60 billion. Mr. Keith Rudolf, Chairman of the ICAA's Legal and Regulatory Committee, also is with me today. Mr. Rudolf serves as Senior Vice President and General Counsel of Stein Roe & Farnham, an investment counsel firm founded in 1932 that manages total client assets in excess of $24 billion.

We are here today representing the Investment Counsel Association of America (ICAA). The ICAA greatly appreciates this opportunity to appear before the Subcommittee to present our views on these important issues.

My statement covers three areas. First, I will describe what the ICAA is and the laws, regulations, and professional standards that govern the legal, ethical, and professional activities of our member firms. Second, I will describe the ICAA's views on legislative proposals being considered by the Securities and Exchange Commission (SEC). Finally, I will set forth the ICAA's concerns about other related legislative proposals that have been advanced and discussed.

I. THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

The ICAA is a national professional association of more than 160 investment advisory firms that collectively manage client assets in excess of $410 billion. Founded in 1937, the ICAA played an active role in assisting Congress to develop and enact the Investment Advisers Act of 1940 (Advisers Act), which serves as the basic statutory framework for our firms' activities. I also am proud to say that partners of Scudder, Stevens & Clark were instrumental in founding the ICAA and in helping to draft the original Advisers Act.

A. Definition of Investment Counsel

All ICAA member firms are entitled to represent themselves as "investment counsel." As such, ICAA member firms constitute a specialized subset of investment adviser firms. Section 208(c) of the Advisers Act provides that:

> It shall be unlawful for any person registered under section 203 of this title to represent that he is an investment counsel or to use the name "investment counsel" as descriptive of his business unless (1) his or its principal business consists of acting as investment adviser, and (2) a substantial part of his or its business consists of rendering investment supervisory services.

"Investment supervisory services" are defined in section 202(a)(13) of the Advisers Act as "the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client."

In a nutshell, this means that ICAA firms are primarily in the personalized investment management business. This key aspect of our businesses also sets us apart from other typical investment advisers. Unlike many other investment advisers, ICAA members sell only investment advice and investment management services to our clients. ICAA members do not participate in any commissions or profits from investment transactions we may recommend to our clients. ICAA members are not compensated according to the volume of transactions as to which we provide investment advice nor do our firms generally have custody of any client funds. Rather, ICAA members are compensated solely on the basis of negotiated fees for investment services rendered (primarily based on a percentage of assets under management).

Clients of ICAA member firms include a broad array of institutional and individual investors, both domestic and foreign, including corporate pension and profit-sharing trusts; charitable, religious, and educational endowments; governmental retirement funds; insurance companies; and mutual funds.

B. Statutory Framework

Since its inception in 1937, the ICAA has supported appropriate federal regulation of its member firms and of the investment advisory industry. The ICAA maintains that appropriate regulation, registration, enforcement, full and fair disclosure, and adherence to high ethical standards of conduct will preserve and enhance the trust and confidence of our members' ~~clients, while encouraging our members to render appropriate and unbiased professional~~ investment advice and counsel to our clients.

At the federal level, the Advisers Act has provided a workable framework within which the ICAA and other investment advisers may properly function. Under the Advisers Act, investment advisers (as described in section 202(a)(11)) are required to register with the SEC (section 203). The SEC is empowered with broad statutory authority to prescribe registration requirements by rule "as necessary or appropriate in the public interest or for the protection of investors." Under the Advisers Act, the SEC also is empowered to censure, place limitations on, suspend, or revoke any such registration for a number of actions, including making false or misleading statements in any registration application; conviction of a felony or misdemeanor involving securities transactions; violating -- or aiding, abetting, counselling, commanding, inducing, or procuring the violation of -- any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Advisers Act, the Commodity Exchange Act, or any rules of the Municipal Securities Rulemaking Board.

Section 204 of the Advisers Act requires each investment adviser to make, keep, furnish, and disseminate such records and reports as the SEC by rule "may prescribe as necessary or appropriate in the public interest or for the protection of investors." Such records are subject to examination by the SEC at such reasonable periodic, special, or other times as deemed necessary by the SEC. Section 204A of the Advisers Act requires each investment adviser to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information by the adviser or anyone associated with the adviser in violation of either the Advisers Act or the Securities Exchange Act of 1934.

Section 206 of the Advisers Act provides that it shall be unlawful for any investment adviser:

1. To employ any device, scheme, or artifice to defraud any client or prospective client.

2. To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

3. Acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as a broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.

4. To engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative (as described in rules and regulations of the SEC).

Additionally, section 207 of the Advisers Act prohibits any person to willfully make any untrue statement of a material fact in any registration application or report filed with the SEC under section 203 or 204 (which includes Form ADV and the brochure rule, as discussed below) or willfully to omit to state in any such application or report any material fact which is required to be stated therein.

With the amendments to the Advisers Act enacted during the 101st Congress, the SEC is now empowered with the full range of potential enforcement powers for any of the violations described above, including criminal penalties, civil monetary penalties, authority to enter an order requiring an accounting and disgorgement, and the ability to enter cease-and-desist orders. The ICAA supported the important statutory changes enacted during the last Congress in order to give the SEC all the tools necessary to enforce the broad mandates of the Advisers Act.

While the foregoing merely highlights the basic aspects of the Advisers Act, the following conclusions should be emphasized:

1. Investment advisers are required, by statute, to comply with all aspects of the Advisers Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Commodity Exchange Act, the rules of the Municipal Securities Rulemaking Board, and the rules and regulations of the SEC issued under the Advisers Act.

2. Investment advisers are subject to a broad range of civil and criminal penalties for failure to comply with the mandates of the Advisers Act and regulations issued thereunder.

3. The SEC is given a broad grant of rulemaking and enforcement authority to mandate registration, disclosure, informational, contractual, and other requirements upon investment advisers, as well as to issue any rules, regulations, and orders "as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission" under the Advisers Act.

In sum, the ICAA believes the Advisers Act has all of the requisite elements to carry out the goals of the law -- to protect the public interest and investors. What is lacking to address concerns that have been raised by this Subcommittee and others is not an appropriate statutory basis, but rather the resources required to enable the SEC adequately to carry out the enforcement and regulation responsibilities already required under the law.

C. Regulatory Requirements

Since enactment of the Advisers Act over 50 years ago, the SEC has exercised the full range of regulatory authorities granted to it under the Advisers Act. An extensive array of rules and regulations has been developed by the SEC during the past 50 years that detail numerous and diverse requirements for advisers. It is beyond the scope of my testimony today to describe in detail all of these regulations. Instead, I will merely highlight the basic regulations of the SEC relating to investment advisers and will remind the Subcommittee of the fact that investment advisers must be familiar with and comply with the voluminous regulations of the SEC under related securities laws.

ICAA member firms are subject to a strict regime of regulatory requirements. First and foremost, under the Advisers Act, a person may not engage in any business as an investment adviser unless registered with the SEC. Section 203 of the Advisers Act sets forth the minimum statutory requirements for SEC investment adviser registration, including the name of the investment adviser, the state in which the adviser is organized, the location of principal and branch offices, the names and addresses of partners, officers, and directors, and the number of the firm's employees; the education, business affiliations during the past 10 years, and present business affiliations of the firm's partners, officers, directors, and of any controlling person; the nature of the firm's business, including the manner of giving advice and rendering analyses or reports; the nature and scope of the authority of the investment adviser with respect to clients' funds and accounts; the basis upon which the investment adviser is compensated; whether the investment adviser, or any person associated therewith, is subject to disqualification under section 203(e) of the Advisers Act; and a statement as to whether the principal business of the investment adviser consists of acting as an investment adviser and whether a substantial part of such person's business consists of rendering investment supervisory services.

Regulations developed by the SEC specify detailed registration and disclosure requirements investment advisers must make (see, 17 C.F.R. Part 275). These registration and disclosure requirements are embodied in the SEC's Form ADV. The ICAA supported the SEC's adoption of a significantly expanded Form ADV in 1979 and supported, along with the North American Securities Administrators Association in 1986, its further revision to improve disclosure regarding compensation arrangements and "financial planning" services. Today, the ADV registration and disclosure form requires investment advisers to provide the SEC with extensive information concerning a number of categories: advisory services and fees; types of clients; types of investments; methods of analysis, sources of information, and investment strategies; education, business standards, and business background; other business activities; other financial industry activities or affiliations; participation or interest in client transactions; conditions for managing accounts; review of accounts; investment or brokerage discretion; additional compensation; and balance sheet information.

The SEC's regulations also require investment advisers to deliver a written disclosure statement on their background and business practices to each advisory client and prospective advisory client (see, 17 C.F.R. 275.204-3). This is referred to as the so-called "brochure rule." Under the brochure rule, an investment adviser may fulfill this requirement by delivering a copy of part II of Form ADV or another document containing at least that information. The rule also requires investment advisers, on at least an annual basis, to offer to clients a free brochure detailing the same information.

Other regulations require investment advisers to keep detailed books and records (that are subject to inspection by the SEC) relating to a wide variety of business activities, including records of receipts and disbursements; ledgers reflecting asset, liability, reserve, capital, income, and expense accounts; a memorandum of any order given by the investment adviser for the sale or purchase of any security; all check books, bank statements, canceled checks, and cash reconciliations of an investment adviser; all bills or statements, paid or unpaid, relating to the business of the investment adviser; all trial balances, financial statements, and internal audit working papers relating to the investment adviser's business; written communications received and sent by the investment adviser relating to advice given; a list of accounts in which the investment adviser is given discretionary power with respect to funds, securities, or transactions of any client; all written agreements entered into by the investment adviser with any client; and a record of every transaction involving a security in which the investment adviser has any direct or beneficial ownership. Other regulations detail the manner in which advertisements of investment advisers may be published, as well as the manner in which funds of clients are to be handled by an investment adviser. Finally, it should be noted that the SEC staff also monitors the use of performance data used by investment advisers. As described below, the ICAA has been instrumental in developing extensive and detailed standards of measurement and use for investment performance data.

Under the Advisers Act, Congress has given the SEC direct and broad authority to promulgate rules and regulations governing the full range of investment adviser business practices, required disclosures to the SEC, investors, and the public, as well as the necessary tools to enforce the extensive regulations that have been developed over the last 50 years. Additional regulation of the investment adviser industry is not needed today. What is lacking are the dedicated resources necessary for the SEC to carry out the many responsibilities with which it has been vested by the Congress to enforce existing regulations and to oversee the adviser industry.

D. State Laws and Regulations

In addition to the federal laws and regulations outlined above, ICAA member firms are subject to a broad array of varying state laws and regulations. It is beyond the scope of this testimony to describe the multitude of local requirements affecting investment advisers. While the ICAA continues to support the strong role the states play in securities regulation, particularly in the area of enforcement, the ICAA is concerned that the wide variation in state laws neither serves to protect investors nor provides an effective framework for consistent regulation and enforcement.

Section 222 of the Advisers Act provides that "[n]othing in this title shall affect the jurisdiction of the securities commissioner (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules or regulations thereunder." While this provision was intended to provide for consistency at both the federal and state levels, the current patchwork of varying state rules and regulations confounds effective and uniform enforcement efforts and leads to needless and burdensome, if not conflicting, requirements for the investment adviser industry.

E. ICAA Policies and Standards

In addition to the federal and state laws and regulations governing investment advisers, the ICAA has adopted policies and standards of practice that govern all ICAA member firms, and has participated with the Institute of Chartered Financial Analysts to create the Chartered Investment Counselor (CIC) program that recognizes excellence and special qualifications of investment counsel. The ICAA standards and policies go beyond the statutory requirements under the Advisers Act and mandate the necessity of providing unbiased and individualized investment advice to each client.

Our by-laws state that the purposes of the ICAA are:

> *To promote integrity, public responsibility and competence in the profession of investment counsel.*
>
> *To promote investment counsel and its objectives of rendering professional, informed, unbiased, and continuous advice to clients based on investment analysis.*
>
> *To consult and cooperate with federal and state governmental agencies and all other interested persons or groups for the development, formulation and enactment of legislation relating to investment counsel and regulations thereunder.*

The ICAA's <u>Standards of Practice for Member Firms</u> were originally set forth in our Code of Professional Conduct in 1937 and constitute the common framework that binds our members together. Firms or individuals that apply for membership in the ICAA are required to undergo a strict review of their records and practices by experienced ICAA representatives to ensure compliance with the Standards of Practice. Continuing compliance with the ICAA's standards is reviewed through the ICAA's Standards of Practice Committee.

Following is a summary of the ICAA's Standards of Practice:

1. Professional Responsibility: The responsibility of investment counsel is to render professional, unbiased and continuous advice to clients regarding their investments. A member firm should devote itself primarily to the performance of this function and services incidental thereto.

2. Professional Qualifications: To enable an investment counsel firm to serve its clientele effectively, its partners and principal personnel should be individuals of experience, ability and integrity.

3. Financial Responsibility: An investment counsel firm should maintain capital and reserves adequate to provide the services for which it was retained.

4. Compensation for Services: Compensation of an investment counsel firm should consist exclusively of direct charges to clients for services rendered and should not be contingent upon the number or value of transactions executed.

5. Investment Counsel Agreements: No assignment of a contract for investment counsel services should be made by a member firm without the consent of the client. A partnership should notify its clients periodically of any change in the firm's membership.

6. Promotional Activities: The content in written or oral statements made by investment counsel firms soliciting new clients should be consistent with the professional nature of investment counsel services.

7. Confidential Relationship: Information concerning the identity of security holdings and financial circumstances of clients is confidential.

The ICAA also has addressed the complexities of the measurement of investment performance. The ICAA's report, The Standards of Measurement and Use for Investment Performance Data, formulates written standards for firms with specific guidelines and background information for compiling and using portfolio performance data. While no minimum, uniform standards exist for all organizations providing investment management services, the ICAA is continuing these and other efforts to implement appropriate standards for its members and the industry.

The ICAA strongly believes that continued adherence to such ethical and professional standards will enable our members to provide our clients with quality and professional investment advice, free from conflicts of interest. The ICAA standards recognize that we are not in the business of "pushing" any particular financial product on a client from which we may benefit financially. We are not in the business of profiting from the volume or type of securities transactions recommended to our clients. Rather, ICAA firms are bound together by the requirement that we are in the sole business of rendering professional, informed, unbiased, and continuous advice to clients based on the individual needs and circumstances of each client.

II. SEC PROPOSALS

Chairman Dodd has requested the ICAA's views on legislative proposals that the SEC may consider, including: (1) imposing an annual fee on investment advisers to fund enhanced inspection and enforcement activities of the SEC; (2) expressly prohibiting advisers from making unsuitable recommendations to clients; and (3) giving the SEC authority to require advisers having custody of client funds or securities to be bonded against larceny or embezzlement. While the ICAA would like to review the details of any such proposal, following are our initial views of each such legislative concept.

A. Fees

For many years, the ICAA generally has supported legislation to allow the SEC to impose and collect periodic fees for registered investment advisers in order to enhance the SEC's ability to perform inspections of the investment advisory industry and to carry out its enforcement and regulation responsibilities under the Advisers Act. We have provided Subcommittee staff with written letters and position papers of the ICAA that demonstrate our organization's historic and continued support for the concept of ensuring that the SEC has adequate resources to perform quality inspections, enforcement, and oversight of the investment adviser industry.

For example, after the July 25, 1991 hearing of the Subcommittee, we wrote to Chairman Dodd, Senator Gramm, and Chairman Breeden to indicate our "wholehearted endorsement" of the concept of imposing periodic fees on investment advisers:

> The ICAA consistently has maintained that the existing scheme of regulation of investment advisers is adequate but that the fundamental problem is the lack of financial and personnel resources needed by the Commission to enforce the existing scheme of regulation and to ensure that the business practices of investment advisers and disclosures to clients and prospective clients conform to the requirements of the law.

As has been pointed out in hearings of this Subcommittee, investment advisers are required under current law to pay only a one-time registration fee of $150. This level of registration fees paid by advisers is disproportionate to the burden imposed on the SEC by law to regulate and oversee the investment advisory industry.

Between 1980 and 1990, the number of registered investment advisers nearly quadrupled to 17,386, while assets under management for such advisers grew to $4.9 trillion. During the same time period, total SEC staff increased to 2,130 full-time employees, an increase of only 4%. In testimony and reports filed with the Subcommittee, the SEC has estimated that on average an investment adviser is inspected once every 30 years.

These facts clearly underscore the need to provide additional dedicated resources to the SEC for inspection and oversight activities of the investment advisory industry. The ICAA supports the concept of requiring annual fees for advisers, provided that such fees are reasonable and are dedicated solely for use by the SEC in undertaking its enforcement and inspection responsibilities under the Advisers Act.

B. Suitability Requirement

The ICAA supports the concept of prohibiting advisers from making unsuitable recommendations to clients. The SEC has stated that such a requirement is merely one aspect of an adviser's fiduciary duty to the client (see, "Financial Planners," Report of the Staff of the United States Securities and Exchange Commission to the House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance, February 1988, p. B-11) and, as discussed above, the ICAA's policies and standards embrace this basic notion. Additionally, broker-dealers are subject to such a suitability requirement under Article III, Section 2 of the NASD Rules of Fair Practice, which states:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for any such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and to his financial situation and needs.

While we question the need for restating existing law and regulatory interpretations, we of course will continue to adhere to the basic premise of requiring advisers to make suitable recommendations for their clients.

C. Bonding

SEC regulations already detail many requirements for advisers who have custody of client funds, including segregation of accounts, separate records of each such account, disclosure to clients of how such funds will be kept, quarterly statements to the client, and an annual surprise audit of each such account. 17 C.F.R. 275.206(4)-2. Additionally, regulations require advisers who have custody or discretionary authority over client assets to disclose to clients a financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to the client. 17 C.F.R. 275.206(4)-4. As discussed above, under section 203(j) of the Advisers Act, the SEC also is authorized to require an accounting and disgorgement, including reasonable interest, for any violation of the Advisers Act or regulations issued thereunder. These and other regulatory requirements are designed to protect investors who deal with investment advisers.

The need for further statutory authority to enable the SEC to require bonding for advisers who have custody of client funds clearly is driven by the desire to provide a recovery to clients who are injured as a result of an adviser's embezzlement or larceny of such funds. While we support the basic intent of such authority, the ICAA strongly believes that any such authority should recognize and appreciate the differences between an adviser's **actual** custody of client funds and securities on the one hand, and, on the other, an adviser's ability to exercise **discretionary** authority over client funds held by an already-bonded third party, typically a bank or brokerage firm. In the former situation, the need for bonding requirements for the adviser is justified to protect the client from larceny and embezzlement by the adviser. In the latter situation, bonding of the adviser may be duplicative, unnecessary, and costly.

While our firms generally do not have actual custody of client funds, it is not infrequent to have a fully negotiated and disclosed arrangement with a client that permits adviser discretion of client funds held by a third party. Typically, client funds or securities are held in a custodial account by a bank or brokerage firm appointed by the client. When the adviser, using its investment discretion, buys a security for the client, a confirmation of the transaction goes to the custodian, who delivers any funds out of its custody only against the receipt of the certificate representing the securities bought. When the adviser, using its investment discretion, sells a security for the client, a confirmation of the transaction goes to the custodian of the client funds, who delivers the certificates representing the securities sold only against its receipt of the cash proceeds of the sale.

Such a system is a closed loop -- the adviser never is able to take possession of either securities or funds of the client. The custodian who has possession of the client's funds or securities is bonded against larceny or embezzlement. In such a situation, we believe there is no need for requiring additional bonding of the adviser. Given the large amount of client assets that our firms manage, the costs of such additional bonding could be significant, if not prohibitive. We believe that imposing such costs on advisers -- and ultimately investors -- is not justified in view of the lack of any demonstrated facts supporting such a requirement.

The ICAA understands the unfortunate situations that have led to this type of proposal and would be pleased to work with this Subcommittee and the SEC to try and address the need for investors to have additional protection against fraudulent and criminal behavior by advisers who have actual custody of client funds. However, we strongly urge this Subcommittee to guard against imposing significant and unnecessary costs on advisers who do not have actual custody of client funds or securities, where sufficient protections and safeguards already exist for the investor/client against larceny and embezzlement.

III. RELATED ISSUES

Finally, we would like to take this opportunity to outline our concerns about other legislative proposals that have been suggested to deal with the problems of inadequate oversight of investment advisers, as well as legislation that would regulate so-called "financial planners." Many of these proposals, in our view, would undermine the goal of achieving a higher level of oversight and enforcement by the SEC of the investment adviser industry and would fail to enhance the protection of investors. As we have suggested above, the current statutory and regulatory requirements are extensive and, in our view, adequate to protect the public interest and investors with respect to the current and projected profile of the investment adviser industry. Additional regulation of the industry -- or additional broadening of the scope of persons regulated under the Advisers Act -- will serve neither the public interest nor the protection of investors.

A. Definition of Investment Adviser

The existing universe of investment advisers is extremely diverse. Even among those who are registered currently with the SEC, it cannot be said that this is a homogeneous industry. There are thousands of advisers affiliated with broker-dealer organizations or with banks; there also are thousands of advisers who, in addition to investment advice, sell financial products or other services, such as insurance. There also are thousands of financial planners, most of whom (as the name implies) render occasional planning services to investors, rather than continuous investment supervisory services. And there are advisers, such as ICAA members, who are investment counsel engaged in rendering unbiased investment advice to clients on a continuous basis.

Given the extreme constraints on the SEC's current resources, we believe it would be unwise and counter-productive to expand significantly the current definition of investment adviser. We strongly believe that all persons and firms that provide investment advice regarding securities should be subject to the regulatory requirements of the Advisers Act, unless excluded for appropriate public policy reasons.

While journalists, state legislators, and some regulators have issued dire warnings about the burgeoning number of "unregulated" financial planners, the ICAA believes that expanding the current definition of investment adviser will strain the resources of the SEC and will fail to add any significant protection to the investing public. Financial planners, to the extent they render advice concerning securities as part of a business, are investment advisers subject to registration, disclosure, and other requirements of the Advisers Act. While many financial planners may be unregistered, they are not unregulated, and existing laws and regulations -- if adequately enforced -- generally would be sufficient to regulate their activities for the protection of investors.

In lieu of amending the scope of the Advisers Act to "bring in" financial planners who are not performing investment adviser functions, the ICAA suggests that Congress should consider other means -- perhaps by clarifying that such persons are subject to state laws and regulations -- to achieve the desired result. Alternatively, the ICAA would support an amendment to the Advisers Act making it unlawful for any person to use certain terms as descriptive of one's business (e.g., financial planner, financial consultant, investment consultant, etc.), unless the person actually provides investment advisory services regarding securities. Such an amendment would be consistent with section 208(c) of the Advisers Act, prohibiting the use of the term "investment counsel" unless the services provided fall within the statutory definition.

The ICAA supports the "functional" approach used by the SEC and many states with respect to investment advisers, focusing on the actual activities of certain persons rather than how such persons describe themselves (see, Investment Advisers Act Release No. 1092, dated October 8, 1987, adopted jointly by the SEC and the North American Securities Administrators Association). In this vein, the ICAA strongly urges the Congress to re-examine the current blanket exemption for banks set forth in section 202(11)(A) of the Advisers Act. The basis for this statutory exclusion -- that banks' securities advisory activities were once limited solely to trust operations -- is no longer viable. Today, the securities advisory activities of banks are functionally indistinguishable from similar activities of non-bank investment advisers and financial planners. Banks now offer many of the same services and compete for the same consumer customers as other investment advisers or financial planners, but do so in a regulatory environment that lacks the strict disclosure and investor protection aspects of federal securities regulation and enforcement. In considering any legislation that seeks to amend the definition of investment adviser, the ICAA strongly believes that Congress should not perpetuate this unjustifiable and archaic exclusion.

B. Enforcement and Private Right of Action

Significant progress was made in enhancing the SEC's resources and enforcement authority during the 101st Congress. The Securities Acts Amendments of 1990 authorized appropriations of $212,609,000 for the SEC for fiscal year 1991. This represents an increase of more than $34 million over the amount authorized for fiscal year 1990. The ICAA strongly supported this increased level of funding for the SEC. Additionally, the Securities Acts Amendments Act of 1990 explicitly gave the SEC authority to appoint and fix the compensation of its employees in carrying out its duties. The ICAA consistently has advocated this type of authority for the SEC to enable the SEC to compete with the private sector to attract and retain talented and competent personnel. Finally, under title IV of the Securities Enforcement and Penny Stock Reform Act of 1990, the Congress authorized the SEC to impose civil penalties under the Advisers Act for any of the following acts or omissions: any willful violation of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, or the Advisers Act; aiding, abetting, counselling, commanding, inducing, or procuring any such violation by any other person; making or causing to be made in any registration statement or other report filed with the SEC under the Advisers Act a statement that was false or misleading with respect to any material fact (or omitting any material fact required to be filed); and failing to supervise another person who commits such a violation. Under the new law, the SEC can impose a penalty for each act or omission up to $100,000 for an individual and up to $500,000 for any other person. The law also gives the SEC the authority to enter an order for violations of the Advisers Act requiring an accounting and disgorgement, including reasonable interest, in addition to any other penalty allowed under the Advisers Act, and to enter a cease-and-desist order for any probable violations under the law.

The ICAA supported these important amendments to the Advisers Act and believes these changes will enhance the ability of the SEC to enforce -- and deter -- violations under the Advisers Act. These dramatic improvements, when combined with existing rights and remedies under both state and federal law, give regulators and private parties extensive and adequate authority to rectify and prevent any wrongdoing by investment advisers.

Despite these encouraging developments, some maintain that a private right of action is needed under the Advisers Act. Proponents of such legislation have advanced two basic arguments in support of such legislation, neither of which bear up under scrutiny.

The first such argument is that no adequate civil remedies exist to redress harm that investors may suffer at the hands of financial planners or investment advisers who defraud their clients. A review of existing federal and state laws clearly indicates otherwise.

The ICAA has found no state in which actual fraud may not be redressed through legal or equitable remedies in state courts. Additionally, most state securities laws provide rescission and other legal and equitable remedies if the fraudulent activity involves the sale or purchase of a security, and the implied right of action in federal courts under section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934 also is available to the injured customer in such a sale or purchase. In addition to these remedies for recovery available to private plaintiffs, civil and criminal enforcement remedies, often including disgorgement for the benefit of injured private parties, are available to federal and state regulators.

Where an injured investor cannot recover funds lost through fraud, it is not because of any lack of adequate legal or equitable remedies. Instead it is usually because the wrongdoer cannot be found or, if located, no longer has any substantial assets to satisfy a judgment.

Enactment of a private right of action under the Advisers Act will do nothing to resolve that very real and unfortunate problem.

The second argument advanced in support of a private right of action is that it would augment the resources of regulators by permitting private plaintiffs to enforce provisions of the law under which the right of action is granted. Unfortunately, such an argument ignores the tremendous costs that would be imposed on the industry, the federal courts, and on investors, if such an augmentation were to occur.

It is anomalous that the Congress would consider the enactment of a new federal private right of action at the same time that concern is growing among the public, the bar, the federal judiciary, and in the Congress itself, regarding the increasing backlog of cases clogging the federal courts. In April 1990, a panel of Members of Congress, judges, and lawyers, appointed by the Chief Justice at the direction of the Congress, released its fifteen month study of the crisis created by the increase in demand for the services of the federal judiciary. That recent study, entitled Report of the Federal Courts Study Committee, responds to "...mounting professional and public concerns with the federal courts' congestion, delay, expense and expansion..." It recognizes, as we all do, that legislation "...also affects the judiciary when it creates new causes of action..." and, among other suggestions, proposes the creation of a mechanism within the judiciary to advise Congress on the potential effects of new legislation on the federal court system. Certainly, a key consideration in this effort to unclog the federal courts is whether a new right of action is required or is essentially duplicative of existing state rights enforceable in state courts. Proposed legislation for violations of the Advisers Act is exactly that: an unnecessary introduction into the federal court system of broad and undefined rights to enforce what really are claims of fraud or negligence, which our state courts are already well-equipped to handle.

Nor do private rights of action come cheap for the industry or for investors. In a time when a trial of even a simple federal cause of action may cost a minimum of $100,000 -- $200,000 in legal fees for each of the plaintiff and the defendant, the settlement even of frivolous claims at their nuisance value will become a very substantial cost of doing business for honest investment advisers -- a cost ultimately borne by their clients. Contingent fee, class action "strike" suits by an aggressive plaintiffs' bar, already common under rule 10b-5 and other provisions of federal securities law, will find a new vitality.

The creation of a private right of action that goes beyond actual fraud (such as violations of section 206 of the Advisers Act) would greatly magnify these dangers and costs. As noted above, the SEC, over the decades, has used the broad grants of authority in the Advisers Act aggressively and expansively in administrative and enforcement proceedings involving advisers, creating a body of administrative law that sweeps within the coverage of the Advisers Act conduct bearing little relationship to traditional concepts of actual fraud. Handing the use of such expansive interpretations to the plaintiffs' bar will invite a long, difficult, and expensive spate of litigation in the federal courts.

Perhaps most disturbing to honest and conscientious professionals in the investment adviser industry is the large potential for application by a creative plaintiffs' bar of a private right of action to mere negligence, actual or alleged, or even honest mistakes in investment judgment, viewed by a plaintiff with the 20/20 vision of hindsight. The very process of evaluating investments and making investment decisions is one of evaluating and balancing potential risks and potential rewards. The concept of risk implies that not all investments will turn out as expected and that factors, both anticipated and unanticipated, may intervene. Yet the assumption of risk is necessary to achieve any reward. The evaluation of investment results in hindsight, combined with the private right of action, will lead invariably to an overall reduction in the level of investment risk that advisers are willing to undertake for their clients, even though it may be completely appropriate and in the client's economic interest to assume greater risk rather than less. We find it particularly disturbing that some would consider such a measure at a time when the Congress is concerned with increasing savings and investment in the nation's economy to enhance competitiveness in the world markets.

The fact of the matter is that existing laws are sufficient to protect investors and that a new federal private right of action will impose tremendous costs on the investment adviser industry, exacerbate the burden on federal courts, and threaten the ability of the investment adviser community to render good faith advice where any significant investment risk is involved. The ICAA strongly believes the Congress should concentrate on ensuring that the SEC has adequate resources to enforce current law, rather than pursuing additional remedies that will do little or nothing to prevent or rectify consumer abuses while possibly diminishing the effectiveness of investment advisers due to the threat of potential liability for any activity that involves risk.

C. Disclosure

As noted above, the ICAA has been a strong and consistent supporter both of full and fair disclosure of conflicts of interest, and of ethical business practices. Adherence to high standards of ethical business conduct, and freedom to the maximum extent possible from conflicts of interest in rendering advice to clients, are the foundations upon which the ICAA was created 55 years ago and which continue to bind our members together today.

The ICAA supported the SEC's adoption of Form ADV in 1979 and supported its revision in 1986 (in association with NASAA) to improve disclosures regarding compensation arrangements and financial planning services. The ICAA assists its members in complying with Form ADV disclosure requirements by promulgating model forms of disclosure concerning some of the very complex and technical issues that must be addressed in properly completing that form, which members then may tailor to their own specific circumstances and business practices.

Proposed legislation would proscribe various business practices, many of which are already proscribed or mandated by existing requirements of the Advisers Act or Form ADV. However, we are troubled by the concept of mandating specific disclosures or prohibiting specific business practices through legislation rather than by regulation. Congress generally has been reluctant to adopt such an approach in the past and should be in this case as well.

The SEC, with its lengthy history of working with investment advisers, possesses a detailed practical knowledge of the industry. The crafting of business practice and disclosure regulations that are appropriate and workable, given the diversity and constant evolution of the industry, is a difficult process at best and one that is never quite finished. The SEC has not been reluctant to proscribe specific business practices or to impose disclosure requirements when a need has been found or an abuse identified. In doing so, the SEC is required to comply with administrative procedures that give the public and industry alike full opportunity to comment and participate in the development of such requirements.

We strongly urge that, should the Congress determine there is a need to impose additional disclosure requirements on advisers or to proscribe business practices not already proscribed, these concerns should be conveyed to the SEC with the mandate that appropriate regulations be adopted to address them within a reasonable period of time, so as to allow the functioning of administrative procedures for comment and discussion.

IV. SUMMARY

The ICAA appreciates this opportunity to testify before the Subcommittee today. We also appreciate Chairman Dodd's leadership in bringing the issue of increased adviser fees for enhanced SEC inspections to the forefront during this Congress. We welcome the opportunity to work with Chairman Dodd and other Members of this Subcommittee to enact legislation this year that will provide the SEC with greater resources to carry out its responsibilities under the Advisers Act.

The ICAA supports the basic concepts of the legislative proposals being considered by the SEC and the Subcommittee, particularly with respect to increased adviser fees. However, we strongly urge the Subcommittee to resist adding provisions to the proposed legislation that will impose additional and unnecessary regulations upon the investment adviser industry without any concomitant gains for investors.

I would be pleased to attempt to answer any questions the Subcommittee may have at this time and we would be pleased to provide any additional information that will be helpful to the Subcommittee in its deliberations.

For more information about the ICAA, please feel free to contact our Washington representative, David G. Tittsworth, at (202) 638-7790.