102D CONGRESS *2d Session*	HOUSE OF REPRESENTATIVES	REPORT 102–

INVESTMENT ADVISER REGULATORY ENHANCEMENT AND DISCLOSURE ACT OF 1992

SEPTEMBER , 1992.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. DINGELL, from the Committee on Energy and Commerce,

submitted the following

R E P O R T

[To accompany H.R. 5726]

[Including cost estimate of the Congressional Budget Office]

The Committee on Energy and Commerce, to whom was referred the bill (H.R. 5726) to amend the Investment Advisers Act of 1940 to improve the supervision of investment advisers, to provide additional investor protections, and for other purposes, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

The amendment is as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Investment Adviser Regulatory Enhancement and Disclosure Act of 1992".

SEC. 2. ADDITIONAL RESOURCES FOR INVESTMENT ADVISER SUPERVISION.

(a) AMENDMENT.—The Investment Advisers Act of 1940 (15 U.S.C. 80b–1 et seq.) is amended by inserting after section 203 the following new section:

"FEES FOR REGISTRANTS AND APPLICANTS

"SEC. 203A. (a) IN GENERAL.—The Commission is authorized, in accordance with this section, to collect fees to recover the costs of registration, supervision, and regulation of investment advisers and their activities. Such fees shall be collected, and shall be available, only to the extent provided in advance in appropriations Acts. No appropriation Act may authorize fees to be collected under this section during any fiscal year unless the amount appropriated by such Act for such costs for such fiscal year equals or exceeds the aggregate amount that may reasonably be expected

to be collected by such fees. Such fees shall be deposited as an offsetting collection to the Commission's appropriation and may remain available for such purposes for the succeeding fiscal year. The costs covered by such fees shall be limited to the costs of Commission expenses for registration, examinations, and surveys of persons registered or required to register under this Act.

"(b) TIME FOR PAYMENT.—

"(1) NEW REGISTRANTS.—At the time of filing an application for registration under this title, the applicant shall pay to the Commission the fee specified in subsection (c). No part of such fee shall be refunded to the applicant. The filing of an application for registration under this title shall not be deemed to have occurred unless the application is accompanied by the fee required under this section.

"(2) ONGOING REGISTRANTS.—Each investment adviser whose registration is effective on the last day of its fiscal year shall pay to the Commission the fee specified in subsection (c). Such payment shall be made not later than 90 days after the end of its fiscal year, or at such other time as the Commission, by rule, shall determine, unless its registration has been withdrawn, canceled, or revoked prior to that date. No part of such fee shall be refunded to the investment adviser.

"(c) COST-BASED SCHEDULE OF FEES.—For any fiscal year for which fees are authorized to be collected by an appropriation Act, the amount of fees due from investment advisers in accordance with paragraphs (1) and (2) of subsection (b) shall be determined according to the following schedule:

"Assets under management	Fee due
Less than $10,000,000	$300
$10,000,000 or more, but less than $25,000,000	$600
$25,000,000 or more, but less than $50,000,000	$1,000
$50,000,000 or more, but less than $100,000,000	$2,500
$100,000,000 or more, but less than $250,000,000	$4,000
$250,000,000 or more, but less than $500,000,000	$5,000
$500,000,000 or more	$7,000.

"(d) ADJUSTMENT OF FEES.—The Commission may, by rule, adjust the fees specified in subsection (c) by a percentage not greater than the percentage change in the Consumer Price Index for All Urban Consumers; U.S. City Average, All Items Index (or a similar successor index of the Bureau of Labor Statistics of the Department of Labor)—

"(1) between the February 1992 version of such index and the most recent version of such index that is in effect; or

"(2) if one or more adjustments have been made under this section after the date of enactment of this section, between the version of such index in effect at the time of the most recent adjustment and the most recent version of such index that is in effect.

"(e) SUSPENSION FOR FAILURE TO PAY.—The Commission, by order, may suspend the registration of any investment adviser if it finds, after notice, that such investment adviser has failed to pay when due any fee required by this section. The Commission shall reinstate such registration upon payment of the fee (and any penalty due), if such suspension was based solely on the failure to pay the fee.

"(f) RULEMAKING.—The Commission may adopt such rules as are necessary to carry out this section.".

(b) EFFECTIVE DATE.—This section shall become effective upon the adoption by the Commission of implementing rules, under section 203A(f) of the Investment Advisers Act of 1940, as added by subsection (a).

SEC. 3. EXAMINATIONS AND SURVEYS.

The Investment Advisers Act of 1940 is amended by inserting after section 222 (15 U.S.C. 80b-22) the following new section:

"EXAMINATIONS AND SURVEYS

"SEC. 223. (a) PERIODIC EXAMINATIONS.—The Commission shall establish and periodically revise a schedule for the regular examination of investment advisers. Such schedule shall provide for more frequent examinations of certain investment advisers based on factors that the Commission determines increase the need for examination of those investment advisers, including the frequency of customer complaints, custody of funds, authority to exercise investment discretion, and receipt of commissions for the sale of investments recommended to clients. In addition, such schedule shall require more frequent examinations in order to—

"(1) assure that new investment advisers have adequate compliance procedures through examinations of investment advisers within approximately one

year of their registration under section 203(a), taking into account the level of risk presented by advisers' activities; and

"(2) conduct follow-up examinations of investment advisers found to have deficiencies that may continue to present high risks to their clients.

"(b) SURVEYS OF UNREGISTERED PERSONS.—The Commission shall, within 3 years after the date of enactment of this section and periodically thereafter, provide for the conduct of a survey to determine the extent of, and reasons for, the failure of persons to register as required by this Act. The Commission shall, on the basis of such survey results, establish objectives for the reduction or elimination of such failures and shall include in annual reports to Congress (under section 23(b) of the Securities Exchange Act of 1934) submitted after completion of the first survey, a statement of such objectives, an evaluation of the success in attaining those objectives during the preceding year, and such recommendations as the Commission considers appropriate to assist in the attainment of those objectives. If the survey identifies any pattern of misinterpretation of the definition of investment adviser as the basis for such failures, the Commission's objectives shall include such rulemaking proceedings as may be required to correct such misinterpretation.

"(c) PROVISIONS NOT LIMITATION.—The provisions of this section shall not be construed to limit the authority of the Commission to conduct an examination or investigation at any time or to institute proceedings under section 203 or 209 of this Act or any other title.".

SEC. 4. DESIGNATION OF SELF-REGULATORY ORGANIZATIONS.

The Investment Advisers Act of 1940 (15 U.S.C. 80b–1 et seq.) is amended by inserting after section 223 (as added by section 3 of this Act) the following new section:

"DESIGNATION OF SELF-REGULATORY ORGANIZATIONS

"SEC. 224. (a) DESIGNATION TO CONDUCT EXAMINATIONS.—The Commission, by rule, consistent with the public interest, the protection of investors, and the purposes of this title, may designate one or more self-regulatory organizations registered with the Commission under sections 6 or 15A of the Securities Exchange Act of 1934, to conduct periodic examinations of its members and affiliates of members to determine compliance with applicable provisions of this title and the rules and regulations thereunder. Such rules shall specify the minimum scope and frequency for such examinations and shall be designed to avoid unnecessary regulatory duplication or undue regulatory burdens. Such self-regulatory organization may discipline its members and affiliates of members for violations of the applicable provisions of this title and the rules and regulations thereunder pursuant to the standards and procedures set forth in sections 6 and 15A of the Securities Exchange Act of 1934. The penalties imposed by a self-regulatory organization for violations of this title shall not exceed those contained in section 217.

"(b) LIMITATION.—The Commission shall not exercise the designation authority contained in subsection (a) for members or affiliates of members if the primary business of the member and its affiliates is investment advisory activities. The Commission, by rule, may establish criteria for defining the term 'primary business'.

"(c) AUTHORITY TO IMPOSE FEES.—

"(1) IN GENERAL.—Any self-regulatory organization designated by the Commission to perform the examinations specified in subsection (a) shall have the authority to collect fees in accordance with this subsection.

"(2) LIMITATION.—The total fee paid by a registered investment adviser under this subsection shall not exceed an amount determined in accordance with rules prescribed by the Commission. Such rules shall require that the fees collected by a self-regulatory organization under this subsection—

"(A) cover only the costs of the self-regulatory organization's expenses for examinations conducted pursuant to subsection (a);

"(B) as to any investment adviser, bear a reasonable relationship to the costs of conducting an examination of that adviser pursuant to subsection (a); and

"(C) not exceed such portion of the fee authorized under section 203A as the Commission determines is allocable to the Commission's expenses for conducting such an examination.

"(3) REDUCTION OF SECTION 203A FEES.—The amount of any fee that a registered investment adviser is required to pay under section 203A with respect to any fiscal year shall be reduced by the amount paid to a self-regulatory organization in accordance with this subsection with respect to such fiscal year.

"(d) EFFECTIVE DATE OF RULE.—A rule prescribed by the Commission under this section shall not be effective until 90 days after the date on which the Commission submits to each House of Congress a report—

"(1) containing the text of the proposed rule and the reasons therefor;

"(2) describing the procedures to be used to coordinate the collection of fees by the Commission under section 203A and by a self-regulatory organization under the rule; and

"(3) containing such other information as may be necessary to describe the implementation and enforcement of the rule.

"(e) DEFINITION.—For purposes of this section, the term 'affiliate' shall mean any person directly or indirectly controlling, controlled by, or under common control with a member.".

SEC. 5. SUITABILITY AND OTHER ADVISER OBLIGATIONS.

(a) AMENDMENT.—Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6) is amended to read as follows:

"PROHIBITED TRANSACTIONS BY INVESTMENT ADVISERS

"SEC. 206. (a) PROHIBITED CONDUCT.—It shall be unlawful for any investment adviser or any person associated with an investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

"(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 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;

"(5) to provide investment advice to any client, other than in connection with impersonal advisory services, unless the adviser—

"(A) prior to providing any investment advice, and as appropriate thereafter, makes a reasonable inquiry into the client's financial situation, investment experience, and investment objectives;

"(B) reasonably determines that the investment advice is suitable for the client; and

"(C) maintains reasonable records, in accordance with such rules as the Commission shall prescribe, of the information obtained from the inquiries the adviser made in complying with this paragraph; or

"(6) to guarantee a client that a specific result will be achieved as a result of the investment advisory services.

"(b) EXEMPTIONS AND SPECIAL RULES.—

"(1) EXEMPTION.—The prohibitions of subsection (a)(3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.

"(2) AUTHORITY TO DEFINE AND PRESCRIBE.—The Commission shall, for the purposes of subsection (a)(4), by rules define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

"(3) DEFINITION OF IMPERSONAL ADVISORY SERVICES.—As used in subsection (a)(5), the term 'impersonal advisory services' means any investment advisory services provided—

"(A) by means of written material or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts;

"(B) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or

"(C) by any combination of the foregoing services.".

(b) RULEMAKING REQUIRED.—The Commission shall prescribe rules for purposes of paragraph (5)(C) of section 206(a) of the Investment Advisers Act of 1940 (as added by subsection (a) of this section) within one year after the date of enactment of this Act.

SEC. 4. ADDITIONAL DISCLOSURE OBLIGATIONS OF INVESTMENT ADVISERS.

(a) ADDITIONAL OBLIGATIONS.—Section 204 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–4) is amended—

(1) by striking the heading of such section and inserting the following:

"PERIODIC REPORTS AND OTHER DISCLOSURE REQUIREMENTS";

(2) by inserting "(a) PERIODIC AND OTHER REPORTS.—" after "SEC. 204."; and

(3) by adding at the end the following new subsections:

"(b) BROCHURE REQUIRED.—

"(1) IN GENERAL.—Each person registered under section 203 of this title shall disseminate to each client or prospective client a document disclosing material facts concerning matters listed in paragraphs (2) and (3) and such other matters as the Commission shall prescribe. In order to provide for timely and effective disclosure of such facts and matters to clients, the Commission shall by rule prescribe the format of the document and the timing of its dissemination.

"(2) CONTENTS OF BROCHURE.—The document required by paragraph (1) shall include information concerning—

"(A) the education and business background of such person and of any associated person providing significant investment advisory services to the client,

"(B) compensation arrangements between the client and the investment adviser,

"(C) the nature of services offered,

"(D) business practices,

"(E) methods for obtaining information on the disciplinary history and registration of the investment adviser and persons associated with the investment adviser, and

"(F) conflicts of interest which could reasonably be expected to impair the rendering of disinterested advice.

"(3) PROMINENT DISCLOSURES.—Such document shall also prominently disclose—

"(A) that—

"(i) the registered person receives or may receive, directly or indirectly, sales commissions or other fees in connection with a purchase or sale effected on behalf of a client; or

"(ii) the registered person will not receive, directly or indirectly, any sales commission or other fees in connection with such purchase or sale, but the client may be charged a sales commission or other fee by another person in connection with such purchase or sale; and

"(B) that remedies may be available to the client with respect to disputes arising out of the advisory relationship.

"(4) DEFINITION.—The Commission shall define 'associated person providing significant investment advisory services to the client' by rule for purposes of this subsection.

"(c) TRANSACTION REPORTS.—

"(1) INITIAL DISCLOSURE.—Each person registered under section 203 shall disclose to each client, before a purchase or sale is effected on behalf of the client—

"(A) the total amount of sales commissions or other fees that may reasonably be expected to be charged or deducted in connection with the purchase or sale;

"(B) that the adviser will receive such amount or a portion of such amount, or, in the case of a transaction to be effected through a broker or a dealer that is a person associated or under common control with the adviser, that the broker or dealer is affiliated with the adviser and will receive such amount or portion of such amount; and

"(C) the existence of any compensation arrangement with an issuer or other third party with respect to the recommended transaction.

Such initial disclosure shall be in writing if the purchase or sale was recommended in writing. The Commission may, by rule, permit an investment adviser to omit disclosure required by this paragraph with the knowing written consent of the client.

"(2) CONFIRMATION.—After such purchase or sale is effected, the investment adviser shall transmit to each client a written statement that discloses—

"(A) the amount of sales commission or other fees that have been charged or deducted in connection with the purchase or sale; and

"(B) the information required to be disclosed by paragraph (1)(C).

"(3) COMMISSION RULES.—The written statement required under paragraph (2) shall be in such form and contain such information, and be provided in accordance with such rules, as the Commission shall prescribe. Such rules shall, to the extent consistent with the protection of investors, permit a confirmation statement of a broker or dealer that contains the information required by this subsection to be used as the written statement required by this subsection.

"(4) EXCEPTIONS.—This subsection shall not apply—

"(A) with respect to any purchase or sale for which the registered person, and any person associated or under common control with the registered person, will not receive any portion of the amount charged or deducted in connection with the purchase or sale, and will not receive any payment under a compensation arrangement required to be disclosed under paragraph (1)(C);

"(B) with respect to accounts for which the person is authorized to exercise investment discretion; or

"(C) with respect to any account for which the person is not acting as an investment adviser.

"(5) SPECIAL RULE.—The provisions of this subsection shall also apply to persons associated with an investment adviser effecting transactions for advisory clients through a broker or dealer with which the person is associated.

"(d) PERIODIC REPORTS.—

"(1) IN GENERAL.—Each person registered under section 203 of this title shall periodically provide to each client a written statement of—

"(A) the sales commissions and other fees paid by the client for all services provided by the registered person and any person associated or under common control with the registered person;

"(B) any amounts received directly or indirectly by the registered person, or any person associated or under common control with the registered person, pursuant to any compensation arrangement with an issuer or other third party with respect to the recommended transaction; and

"(C) such other matters as the Commission shall prescribe.

"(2) COMMISSION RULES.— The Commission shall prescribe by rule the format of the statement and timing of its delivery. Such rule shall require that the format and timing of delivery be designed to present the required information in a manner that readily permits clients to compare the costs charged by the investment adviser with the costs charged by other advisers for comparable services. In adopting such rules, the Commission shall require an investment adviser whose clients purchase or sell investment products through persons other than such adviser, or persons associated or under common control with such adviser, to indicate to its clients that such information concerning costs charged does not include commissions or other fees paid in connection with such purchases or sales. The Commission's rules under this subsection shall permit a periodic report of a broker or dealer that contains the information required by this subsection to be used as the periodic report required by this subsection. The Commission may, by rule, permit an investment adviser to provide the statement required by paragraph (1) no more frequently than annually if the client knowingly waives, in writing, the right to obtain such statement more frequently than annually.

"(3) EXCEPTION.—This subsection shall not apply with respect to any account for which the person is not acting as an investment adviser.

"(e) FACILITIES FOR FILING RECORDS AND REPORTS.—The Commission, by rule, may require any investment adviser—

"(1) to file with the Commission any fee, application, report, or notice required by this title or by the rules issued under this title through any person designated by the Commission for that purpose; and

"(2) to pay the reasonable costs associated with such filing.".

(b) RULEMAKING REQUIRED.—The Commission shall prescribe rules for purposes of subsections (b), (c), and (d) of section 204 of the Investment Advisers Act of 1940 (as added by subsection (a) of this section) within one year after the date of enactment of this Act.

SEC. 7. BOND REQUIREMENT.

Section 208 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–8) is amended by adding at the end the following:

"(e) BOND REQUIREMENT.—

"(1) IN GENERAL.—The Commission shall require, by rules for the protection of investors, that any investment adviser registered under section 203 who—

"(A) is authorized to exercise investment discretion, as defined in section 3(a)(35) of the Securities Exchange Act of 1934, with respect to an account,

"(B) has access to the securities or funds of a client, or

"(C) is an investment adviser of an investment company, as defined in section 2(a)(20) of the Investment Company Act of 1940,

shall obtain a bond from a reputable fidelity insurance company against larceny and embezzlement in such reasonable amounts and covering such officers, partners, directors, and employees of the investment adviser as the Commission may prescribe.

"(2) CONSIDERATIONS IN RULEMAKING.—In implementing paragraph (1), the Commission shall consider—

"(A) the degree of risk to client assets that is involved;

"(B) the cost and availability of fidelity bonds;

"(C) existing fidelity bonding requirements; and

"(D) any alternative means to protect client assets.".

SEC. 8. DISQUALIFYING CONDUCT.

(a) AMENDMENT.—Section 203(e) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3(e)) is amended—

(1) by redesignating paragraphs (3) through (7) as paragraphs (4) through (8); and

(2) by inserting after paragraph (2) the following new paragraph:

"(3) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any crime that is punishable by imprisonment for one or more years and that is not described in paragraph (2) of this subsection or of a substantially equivalent crime by a foreign court of competent jurisdiction.".

(b) CONFORMING AMENDMENTS.—Section 203 of such Act is further amended—

(1) in subsection (e)(6) (as redesignated by subsection (a) of this section, by striking "this paragraph (5)" and inserting "this paragraph (6)";

(2) in subsection (f)—

(A) by striking "paragraph (1), (4), (5), or (7)" and inserting "paragraph (1), (5), (6), or (8)"; and

(B) by striking "paragraph (3)" and inserting "paragraph (4)"; and

(3) in subsection (i)(1)(D), by striking "section 203(e)(5) of this title" and inserting "subsection (e)(6) of this section".

SEC. 9. CONFIDENTIALITY.

Section 208 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–8), as amended by section 7, is further amended by adding at the end the following new subsection:

"(f) DISCLOSURE OF CLIENT INFORMATION PROHIBITED.—

"(1) ADVISER DISCLOSURE.—It shall be unlawful for any investment adviser to disclose any personally identifiable financial information with respect to any client unless required by law to do so, or unless—

"(A) the client has been adequately informed of the proposed information disclosure, in accordance with rules prescribed by the Commission, and (i) has been afforded the opportunity, in accordance with such rules, to object to the disclosure, and (ii) has not objected or has affirmatively consented;

"(B) the information disclosed is necessary and appropriate in order to establish an advisory or brokerage account or to effect or attempt to effect a transaction for the client;

"(C) the information is requested by representatives of the Commission, a State agency whose primary assignment is the regulation of the securities business, or a self-regulatory organization in connection with their respective regulatory or enforcement responsibilities as to the investment adviser or the information is requested by a Commission subpoena; or

"(D) the information is requested by the client's auditors or accountants.

"(2) SECONDARY DISCLOSURE.—It is unlawful for any person to whom information is disclosed for the purpose described in paragraph (1)(B) to use such information for any purpose other than the effectuation of the client's transaction.".

SEC. 10. FEDERAL-STATE COOPERATION.

Section 209 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–9) is amended by adding at the end the following new subsection:

"(f) FEDERAL-STATE COOPERATION.—

"(1) AUTHORITY.—The Commission is authorized to cooperate with State agencies whose primary assignment is the regulation of the securities business or any association of State securities officials they designate, and which, in the judgment of the Commission, could assist in obtaining greater effectiveness in

Federal and State regulation of investment advisers. The Commission shall cooperate, coordinate, and may (in its discretion) share information with such agencies or associations for the purposes of carrying out the policies and purposes set forth in paragraphs (2) and (3).

"(2) POLICY.—It is the declared policy of this subsection that there should be greater Federal and State cooperation and coordination in the regulation of investment advisers in order to achieve—

"(A) maximum effectiveness of regulation, examination, and enforcement, and

"(B) maximum uniformity in Federal and State regulatory standards.

"(3) PURPOSE.—The purpose of this subsection is to engender cooperation between the Commission, any such agencies or associations, and other duly constituted securities associations in the following areas:

"(A) the sharing of information regarding the registration or exemption of investment advisers and the conduct of their business in the various States;

"(B) the development and maintenance of uniform examination standards and procedures; and

"(C) the development of a uniform exemption from registration for small investment advisers which can be agreed upon among several States or between the States and the Federal Government where consistent with the public interest and the protection of investors and the purposes of this Act.

Nothing in this subsection shall be construed as authorizing the preemption of State law.

"(4) STUDIES AND RECOMMENDATIONS.—In order to carry out these policies and purposes, the Commission shall conduct such studies and meetings as the Commission considers necessary. The Commission shall submit to Congress, not later than 2 years after the date of enactment of this subsection, any legislative recommendations necessary to carry out the policy and purpose of this subsection.".

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PURPOSE AND SUMMARY

This legislation amends the Investment Advisers Act of 1940 (Advisers Act) to establish a fee structure for registered investment advisers in order to provide the Securities and Exchange Commission (Commission) with additional resources with which to conduct its regulatory activities. This legislation also provides enhanced protection to investors employing the services of investment advisers, including financial planners, by increasing the frequency of Commission examinations of high-risk advisers, by establishing a mechanism for the identification of unregistered advisers, by establishing an express suitability standard, by improving disclosures of conflicts of interest and other pertinent information, by requiring fidelity bonds of certain advisers, by providing for financial information to remain confidential unless consent is given for it to be disclosed, and by encouraging strong state-federal cooperation in the regulation of investment advisers.

The legislation would create a new Section 203A of the Advisers Act, which would require advisers to pay annual fees on a sliding scale linked to assets under management. These fees would be used as offsetting collections to recover the cost of an increase in the Commission's investment adviser inspection staff and to conduct surveys of unregistered advisers. The legislation also adds a new Section 223 to the Advisers Act, which would provide specific direction to the Commission with respect to inspections based on risk factors, first-year inspections for new

advisers, and follow-up inspections. New Section 223 would also require the Commission to conduct surveys of unregistered advisers, and to develop a plan of action to deal with any failure-to-register patterns, including a rulemaking to correct any "pattern of misinterpretation" of the definition of "investment adviser." The bill would also create a new Section 224, which would authorize the Commission to designate a self-regulatory organization (SRO) to conduct inspections of investment advisers that are also brokerdealers or affiliates of broker-dealers.

An express suitability provision would be created for the enhanced protection of investors by adding a new subsection (a)(5) to Section 206, the antifraud section of the Advisers Act. This provision would codify existing implied suitability requirements and would add a record-keeping requirement to permit verification of suitability determinations. In addition, the legislation would add a new subsection (b) to Section 204 of the Advisers Act, which would provide for a three-part disclosure obligation: (1) a brochure with "generic" disclosures about the background of the adviser, whether the adviser receives commissions for the sale of investment products, and other pertinent information; (2) transaction reports regarding the amount of any commissions or fees to be charged or deducted and the existence of any third party payments with respect to any particular transaction made prior to the transaction and confirmed thereafter; and (3) periodic reports containing summaries of the charges incurred by a client over time and the amounts received by the adviser with respect to a client's

account. The bill would also amend Section 208 of the Advisers Act to require the Commission to mandate a fidelity bond for advisers with custody of or discretion over client assets, or for advisers that advise investment companies.

The legislation also would add to the list of disqualifying conduct in Section 203(e) of the Advisers Act any crime punishable by imprisonment for one or more years, thus adding to the public protection by authorizing the Commission to deny registration as investment advisers to those persons who commit any type of felony. Additionally, the bill would amend Section 208 of the Advisers Act by adding a new subsection (f), which would generally prohibit personally-identifiable financial information about a client to be disclosed by an adviser without the client's consent. Some exceptions to this rule are included. The legislation would amend Section 204 of the Advisers Act by adding a new subsection (e), which would authorize the Commission to develop a "one-stop" filing system which would allow advisers to make one filing that would be transmitted to the Commission and the states, thus reducing paperwork for advisers and regulators. Finally, the legislation would add a new subsection (f) to Section 209 of the Advisers Act that would encourage federal-state cooperation in order to achieve a higher degree of uniformity among the states and between state and federal law.

BACKGROUND AND NEED FOR THE LEGISLATION

Regulatory and Statutory Framework

1. General Coverage of the Advisers Act

Federal regulation of investment advisers is provided for by the Advisers Act.[1] The Advisers Act defines the term investment adviser to include "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."[2] In other words, the definition covers any individual or firm that receives compensation for giving advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications.[3] The definition excludes

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1 Investment Advisers Act of 1940, 15 U.S.C. Section 80b-1 et seq.

2 15 U.S.C. Section 80b-2(a)(11). See also Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987) (Release 1092).

3 For the purposes of this Report, the terms "investment adviser" and "financial planner" will not be distinguished. In general, however, financial planners conduct a more retail-oriented business. Most planners are thought to practice either alone or in small, locally-based partnerships or companies, and to focus on a broad range of investment options, such as insurance and real estate, in addition to securities. Notwithstanding the different terminology, financial planners who give advice about securities are required to register under the Advisers Act unless an exemption is available. See Release 1092, supra note 2; and Financial Planners: Report of the Staff of the United States Securities and

(Footnote continued)

banks,[4] and also excludes lawyers, accountants, engineers or teachers rendering such advice solely incidental to their profession.[5] The Act further excludes any broker-dealer where the advisory services are "solely incidental to the conduct of his business as a broker or dealer" and are provided without "special compensation."[6]

In general, the Advisers Act requires that individuals or firms meeting the definition of investment adviser register with the Commission.[7]

> Sec. 203 [80b-3](a) Except as provided in subsection (b), it shall be unlawful for any investment adviser, unless registered under this section, to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser.

Investment advisers, regardless of their size, currently pay a one-time fee of $150 when they apply for registration.[8]

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[3] (continued)
Exchange Commission to the House Comm. on Energy and Commerce's Subcomm. on Telecommunications and Finance, at 6-10 (February 1988) (Financial Planners Study).

[4] 15 U.S.C. Section 80b-2(a)(11)(A).

[5] 15 U.S.C. Section 80b-2(a)(11)(B).

[6] 15 U.S.C. Section 80b-2(a)(11)(C).

[7] Subsection (b) of Section 203 provides certain limited exemptions from registration for, among others, an adviser with fewer than fifteen clients that does not hold itself out to the public as an investment adviser and does not advise a registered investment company. 15 U.S.C. Section 80b-3(b).

[8] 17 C.F.R. Section 275.203-3(a). The fee was set by the Commission in 1972 pursuant to the Independent Offices Appropriations Act. The fees that the Commission collects are paid into the
(Footnote continued)

The registration process also requires that investment advisers submit applications that include the brochure they are required to provide to clients under the Commission's "brochure rule."[9] The Commission reviews the applications only to assure that advisers provide all requested information and to determine that certain business practices described in the application comply with the law. The Commission does not evaluate adviser competence, nor does it verify as correct any of the information submitted during the registration process except information concerning Commission disciplinary history. Registration is then granted by the Commission within 45 days.[10] Registration may be denied if the Commission finds that the applicant has made false or misleading statements to the Commission; has been convicted of certain specified felonies in the previous ten years; or has been found to have engaged in specified violations of the securities laws.[11] Applications are rarely rejected. Once registered, investment advisers are then subject to periodic Commission examinations, recordkeeping requirements,[12] and certain substantive obligations, including disclosure requirements[13] (see discussion <u>infra</u> under

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[8] (continued)
General Fund of the Treasury, and are not available to the Commission to fund the administration and enforcement of the Advisers Act.

[9] 17 C.F.R. Section 275.204-3. Such information includes education and business background, business practices and potential conflicts of interest. <u>See generally</u> Part II of Form ADV, 17 C.F.R. Section 279.1, which advisers may deliver to satisfy the brochure rule.

[10] 15 U.S.C. Section 80b-3(c)(2)(A).

[11] 15 U.S.C. Section 80b-3(c)(2)(B).

"Commission Regulation Under the Advisers Act.").

2. Commission Regulation Under the Advisers Act

The Advisers Act imposes three types of requirements on registered investment advisers: (1) a fiduciary duty to clients enforceable through its antifraud provisions; (2) substantive provisions that, among other things, require certain disclosures to clients; and (3) recordkeeping requirements. In addition, the Act provides for administrative oversight by the Commission, primarily through inspections,[14] and provides for certain penalties for violation of the Act. As described below, there are only limited private remedies under the Act.

A. Fiduciary Duty to Clients

The antifraud provisions of the Advisers Act require advisers to meet the high standards owed by persons who are fiduciaries.[15] In SEC v. Capital Gains Research Bureau, Inc., the U.S. Supreme Court held that an adviser owes his or her clients an "affirmative duty of 'utmost good faith and full and fair' disclosure of all material facts."[16] These duties are enforceable through the

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12 15 U.S.C. Section 80b-4.

13 17 C.F.R. Section 275.204-3.

14 15 U.S.C. Section 80b-4.

15 15 U.S.C. Section 80b-6.

antifraud provisions of the Advisers Act.

B. Substantive Provisions

The Advisers Act and rules that the Commission has adopted contain a number of substantive requirements designed to protect advisory clients. These substantive rules govern the types of fees that advisers can charge;[17] their ability to engage in principal and agency cross transactions with clients;[18] and advertising[19] and solicitation[20] practices. Advisers with custody of client securities or funds must establish practices designed to safeguard them.[21] Advisers are required to supervise the advisory practices of their employees[22] and establish procedures to prevent insider trading.[23]

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16 375 U.S. 180, 184 (1963).

17 15 U.S.C. Section 80b-5(a)(1). The Act limits the ability of advisers to charge "performance fees," which are based on the advisers success in managing the client's money. See also 17 C.F.R. Section 275.205-3.

18 15 U.S.C. Section 80b-6(3). Principal transactions involve the sale of a security owned by the adviser to the client. Agency cross transactions involve the adviser acting as broker for a person selling to or buying a security from a client of the adviser. See also 17 C.F.R. Section 275.206(3)-2.

19 17 C.F.R. Section 275.206(4)-1.

20 17 C.F.R. Section 275.206(4)-3.

21 17 C.F.R. Section 275.206(4)-2.

22 15 U.S.C. Section 80b-3(e)(5).

23 15 U.S.C. Section 80b-4A.

The Commission's "brochure rule"[24] requires registered investment advisers to provide clients with information about the adviser's education and business background and its business practices, including fees. The information required to be disclosed is specified in the Commission's Form ADV.[25] Additionally, Rule 206(4)-4[26] requires an adviser to disclose to clients any disciplinary history and, under certain circumstances, financial information[27] that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients.

C. Recordkeeping Provisions

As stated above, investment advisers must maintain prescribed books and records and make them available to Commission examiners. The Commission examines registered investment advisers to help ensure compliance with the various federal requirements as to recordkeeping, reporting, advertising, conflicts of interest, and other matters, and to determine if advisers are acting in accordance with the disclosures and representations made to

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24 17 C.F.R. Section 275.204-3.

25 Part II of Form ADV, *supra* note 9.

26 17 C.F.R. Section 275.206(4)-4.

27 A financial condition likely to impair the adviser's ability to meet its contractual commitments is required to be disclosed where the adviser has discretionary authority or custody over client assets, or if advisory fees of more than $500 are payable six months or more in advance.

clients.

D. Administrative Oversight

The Commission's primary means of administering the Advisers Act is through inspections. There are two types of inspections: routine inspections and "cause" inspections. Cause inspections result from the Commission learning of problems as a result of public complaints, tips, or newspaper articles.

E. Penalties and Remedies

Under the Advisers Act, the Commission can deny an application for registration or suspend or revoke the registration of an adviser if the applicant or adviser has been convicted of specified felonies within the previous ten years, has been found to have violated federal or foreign securities laws, or has engaged in other specified misconduct.[28] The Commission may also censure or place limitations on an associated person of an investment adviser who is found to have engaged in such activities.[29] In addition, the Commission may issue cease and desist orders to prevent or halt violations of the Advisers Act,[30] and may order an accounting and disgorgement[31] and impose civil money penalties for violations of

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28 15 U.S.C. Sections 80b-3(c)(2) and (e).

29 15 U.S.C. Section 80b-3(f).

30 15 U.S.C. Section 80b-3(k).

the Advisers Act or rules adopted under the Act.[32] Finally, the Commission can bring an action in federal court to stop an adviser from committing any ongoing violations of the Advisers Act and to prevent future violations.[33] In the context of the court action, the Commission can seek disgorgement and penalties.[34]

No private right of action for damages has been read by courts into the Advisers Act through the antifraud provisions, however.[35] While some commentators have decried this absence of an express private right of action under the Advisers Act, and even Commissioners of the Securities and Exchange Commission have urged Congress to include such a right of action in amendments to the Act,[36] others argue that such a provision would be duplicative of causes of action that currently exist under both state and federal

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31 15 U.S.C. Section 80b-3(j).

32 15 U.S.C. Section 80b-3(i).

33 15 U.S.C. Section 80b-9(d).

34 15 U.S.C. Section 80b-9(e).

35 In _Transamerica Mortgage Advisors, Inc. v. Lewis_, 444 U.S. 11, 24 (1979), the Supreme Court refused to recognize an implied private cause of action for damages under the anti-fraud provisions of the Advisers Act. This decision effectively precludes victims of investment adviser fraud and abuse from invoking the adviser's fiduciary obligations under the Act as a means of securing redress for harms sustained as a result of the fraud. As discussed _infra_, the Court did recognize a private right of action for equitable relief, including rescission of the advisory contract and restitution of fees.

36 _See, e.g._, _Financial Planners: Hearing on H.R. 3054 and H.R. 4441_ before the House Subcomm. on Telecommunications and Finance, 101st Cong., 2d Sess. (July 18, 1990) (statement of the Honorable Mary L. Schapiro, Commissioner, Securities and Exchange Commission).

law. Upon consideration of this debate, the Committee has concluded that, while an express private right of action has the advantage of locating in one convenient place the elements of a federal cause of action, current law provides an adequate set of remedies for persons injured by the fraudulent acts of investment advisers. Therefore, the legislation does not include an express private right of action in the Advisers Act.

Almost all investment adviser fraud occurs in connection with the purchase or sale of a security, and advisory clients can almost always sue under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act)[37] and Rule 10b-5 promulgated thereunder.[38] The courts have interpreted the "in connection with" requirement of Rule 10b-5 broadly.[39] Any fraud that is reasonably calculated to affect the investment decision of a reasonable investor will satisfy this requirement,[40] although there must be an actual purchase or sale.[41] Thus, under Rule 10b-5, the fraud must bear "some nexus but not necessarily a direct and close relationship" to

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37 15 U.S.C. Section 78j(b).

38 17 C.F.R. Section 240.10b-5.

39 See, e.g., SEC v. Drysdale Secs. Corp, 785 F.2d 38, 42 (2d Cir. 1986), cert. denied sup nom. Essner v. SEC, 476 U.S. 1171 (1986); Brown v. Ivie, (5th Cir. 1981) 661 F.2d 62, 65, cert. denied, 455 U.S. 990 (1982); First Va. Bankshares v. Benson, 559 F.2d 1307, 1315 (5th Cir. 1977), cert. denied sub nom. Walter E. Heller & Co. v. First Va. Bankshares, 435 U.S. 952 (1978). While it is possible to construct hypothetical situations that involve adviser fraud not in connection with the purchase of sale or a security, such frauds would be extremely rare and probably susceptible to action pursuant to state common law fraud.

40 Id.

the purchase or sale of a security.[42]

As a result, Rule 10b-5 covers a broad range of fraudulent adviser conduct and has permitted defrauded advisory clients to sustain private actions for conduct such as scalping,[43] failing to disclose conflicts of interest[44] and employing risky strategies where the client believes more conservative ones are in fact being used.[45]

In addition to remedies under Section 10(b) and Rule 10b-5, Section 215 of the Advisers Act confers a private right of action for equitable relief.[46] An injured investor can sue an adviser for rescission of the advisory contract and restitution of advisory fees.[47] The Commission also has the authority to enter an order

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41 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

42 Levine v. Futransky, 636 F. Supp. 899, 901 (N.D. Ill. 1986).

43 See, e.g., Zweig v. Hearst Corp., 594 F.2d 1261, (9th Cir. 1979) (financial columnist "adviser" liable for "scalping" under Rule 10b-5 after disseminating favorable statements about companies in which adviser had invested to drive up stock price, and then selling his personal holdings). See also Securities and Exchange Commission v. Blavin, 557 F. Supp. 1311 (E.D. Mich. 1983), aff'd 760 F.2d 711 (6th Cir. 1985).

44 See, e.g., Laird v. Integrated Resources, Inc., [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) Paragraph 95,013 (5th Cir. 1990) (holding that an adviser's failure to disclose his receipt of commissions on products he recommended was actionable under Rule 10b-5).

45 Levine v. Futransky, supra note 42, at 901.

46 15 U.S.C. Section 80b-15.

47 Although the Supreme Court held in Transamerica Mortgage, 444
(Footnote continued)

requiring a person to cease and desist violations of the Advisers Act and requiring an accounting and disgorgement from a person that has violated the Advisers Act.[48] In addition, in cases brought in court by the Commission involving adviser fraud, courts have ordered disgorgement by the adviser, creating a pool of assets from which injured clients could recover their losses.[49]

Where federal remedies are not available, clients may have recourse under state law. Section 410(b) of the investment adviser provisions of the Uniform Securities Act of 1956, as amended, contains a private right of action for fraud. More than twenty states have adopted statutes regulating advisers that provide for a private right of action for fraud.[50]

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[47] (continued)
U.S. 11, 24 (1979), that Section 206 of the Advisers Act does not confer a private right of action for damages, it said that a client may bring a private action against the adviser for rescission of the advisory contract, for an injunction against continued operation of the contract, and for restitution.

[48] Section 203(j) and (k) of the Advisers Act, 15 U.S.C. Sections 80b-3(j), 3(k), were enacted as part of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.

[49] For example, in one recent and notorious case, an adviser consented to the entry of a court order settling the action brought by the Commission which provided, among other things, that the court would retain jurisdiction for purposes of determining the amounts, if any, to be disgorged by the adviser. See Investment Adviser Industry Reform: Hearings before the House Subcommittee on Telecommunications and Finance, No. 102-128, (June 10, 1992) (Hearings) (testimony of the Honorable Richard C. Breeden, Chairman, Securities and Exchange Commission) at 98, note 1, citing Securities and Exchange Commission v. Institutional Treasury Management, Inc., Denman & Company and Steven D. Wymer, Civ. A. No. 91-6715 RG (Ex)(C.D. Cal.), Litigation Rel. No. 13131 (Dec. 12, 1991).

In addition to civil actions under state adviser laws, remedies may exist under traditional common law theories. For example, an adviser who fraudulently makes a misrepresentation is subject to liability in deceit, for pecuniary loss.[51] Fraud or wrongdoing by the adviser may also constitute a breach of the adviser's contractual duties.[52] As in any fiduciary relationship, there are appropriate remedies against a fiduciary who has violated his duties, including breach of fiduciary duty and constructive fraud,[53] negligence,[54] and conversion.[55]

3. State Investment Adviser Laws

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50 See Hearings, supra note 49, at 140 (statement of Lewis W. Brothers, President, North American Securities Administrators Association (NASAA)).

51 Restatement (Second) of Torts Section 525 (1977). See also Peterson v. Baloun, 715 F. Supp. 212, 216 (N.D. Ill. 1989) (denying defendant's motion to strike pendent claim for state common law fraud against adviser); Lazzaro v. Holladay, 443 N.E.2d 1347 (Mass. App. Ct. 1983) (finding that plaintiff's amended complaint, which alleged that defendant investment advisers had misrepresented and failed to disclose material information, met relevant specificity requirements).

52 See 12 S. Williston, A Treatise on the Law of Contracts, Section 1523 (3d ed. 1970).

53 See, e.g., Stokes v. Henson, 265 Cal. Rptr. 836, 841-43 (Cal. Ct. App. 1990) (adviser breached fiduciary duty by failing to make disclosures, making misrepresentations, and improperly intermingling funds).

54 Garrett v. Snedigar, 359 S.E.2d 283, 286-88 (S.C. App. 1987) (permitting plaintiffs to maintain action for negligence against investment adviser).

55 In Corwin v. Marney, Orton Investments, 788 F.2d 1063 (5th Cir. 1986), cert. denied, 488 U.S. 924 (1988), the court reversed
(Footnote continued)

The oversight of investment advisers and financial planners is a shared state-federal responsibility involving both the individual states and the Commission. Currently, 43 states have investment adviser laws which focus primarily on the individual providing the advice rather than on the firm.[56] Generally, state laws are very similar to the federal Advisers Act. Some state laws are designed to compensate for what are perceived as gaps in the federal law and, for example, require: (1) registration of investment adviser representatives;[57] (2) competency screening of applicants;[58] (3) financial stability requirements;[59] and (4) prohibitions on unfair and unethical business practices.[60] As noted above, more than 20 states have an express private right of action on the books

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[55] (continued)
in part the district court's dismissal of an action against an investment adviser who promoted real estate investments alleging not only federal claims, but also violations of state securities laws, breach of contract, breach of fiduciary relationship, misrepresentation and common law fraud, statutory real estate fraud, malpractice, and conversion.

[56] Hearings, supra note 49, at 138 (statement of Lewis W. Brothers, Jr.).

[57] Twenty-six of the 43 states that currently oversee the activities of investment advisers also require that investment adviser representatives register with the state securities agency. Under federal regulations, a single "person" (whether a corporate entity or an individual) is the registrant. Hearings, supra note 49, at 139 (statement of Lewis W. Brothers, Jr.).

[58] A significant preventative authority granted to most state securities agencies is the ability to consider the training, experience and knowledge of an investment adviser applicant and the authority to require an examination of such applicant as a condition of registration. Currently, at least 31 states assert this prerogative by setting standards of experience, education and/or successful completion of certain examinations to assure some minimum measure of competence on the part of the persons holding themselves out to the public as experts in the investment advisory

(Footnote continued)

specifically tailored to investment advisory practices.[61]

Deficiencies In Current Framework

1. Inadequate Resources

Current Commission resources are insufficient to fund an examination and supervisory program adequate to the task of regulating the more than 17,000 advisers currently registered with the Commission. Over the past ten years, the examination cycle for registered investment advisers has slowed from once every 12 years to once approximately every 30 years. Tremendous growth in the adviser industry has been severely undermatched by increases in

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[58] (continued) field. Id.

[59] Approximately 20 states require some demonstration of financial stability by requiring an investment adviser to meet certain net capital, net worth or net tangible asset standards and/or produce a surety bond in a specified amount. An additional eight states impose such requirements if the adviser accepts custody, discretionary authority or prepaid fees from clients. Id.

[60] A number of states have adopted a detailed code of ethics for investment advisers, including suitability requirements. Id. at 140. Furthermore, most state investment adviser laws include somewhat broader antifraud provisions than those found in the federal law. This is accomplished by the substitution of "any person" for any "investment adviser" in the language preceding the fraudulent practices provisions. The result is that the state antifraud provisions reach anyone receiving compensation for advice on the value, purchase or sale of a security, whether or not the individual is "in the business" or otherwise excluded from the definition of investment adviser. Id.

[61] Id.

Commission resources available for regulation of the industry. For example, on average, about 60% of the advisers registered for more than one year in the Commission's Chicago, Denver, Los Angeles, and New York regions have never been inspected. These regions are responsible for inspecting approximately 59 percent of the total registered investment adviser population.[62]

The big picture confirms this snap-shot. Over the ten years between 1981 and 1991, the number of Commission adviser examiners increased by only 28 percent, from 36 to 46 examiners, with the percentage of advisers examined each year decreasing substantially from 8 percent in 1981 to only 3 percent in 1991.[63] According to the Commission, during this same period, the number of planners and advisers registered with the Commission increased from 5,100 to approximately 17,500, an increase of over 240 percent, and assets managed by advisers rose from $450 billion to $5.4 trillion, an increase of more than 1,100 percent.[64] This amount represents more than twice the amount deposited in U.S. commercial banks.[65] In each of the last three years, approximately 2,500 new advisers have registered with the Commission.[66] Thus, despite a 28 percent

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[62] General Accounting Office, Investment Advisers: Current Level of Oversight Puts Investors at Risk, GAO-GGD-90-83, at 20 (1990) (GAO Report).

[63] Hearings, supra note 49, at 96 (statement of the Honorable Richard C. Breeden, Chairman, Securities and Exchange Commission).

[64] Id. at 90.

[65] Id., citing Fed. Res. Bull., Apr. 1992, at A19 (data as of Jan. 1992).

increase in examiner resources, the ratio of advisers to examiners grew from 142 advisers for each examiner to 380 advisers for each examiner.[67]

The Commission has attempted to deal with this growth in a number of ways. Chairman Shad testified before the Subcommittee on Telecommunications and Finance in 1986 that, because of the increasing number of registered advisers, the Commission had begun to target its inspections on firms that present the highest risks to clients and that the Commission was beginning to use new techniques to increase the productivity of its inspections.[68] In addition, the Commission testified that it had begun coordinating inspections with other state and federal regulators as well as SROs.[69] In 1988, faced with the continued growth in the number of advisers, the Commission proposed to turn over primary responsibility for the regulation of smaller advisers to states by exempting them from most federal regulation.[70] Finally, in 1989,

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66 Id.

67 Id. at 96.

68 Investment Advisers, Financial Planners and Customer Protection: Hearing Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 99th Cong. 2nd Sess. 17-18 (1986) (Consumer Protection Hearing) (statement of the Honorable John Shad, Chairman, Securities and Exchange Commission). For example, the Commission has greatly expanded the use of computers in its inspection program. See Investment Advisers Act Rel. No. 952 (Jan. 11, 1985) (permitting advisers to keep records on computer systems).

69 Consumer Protection Hearing, supra note 68, at 19.

70 Investment Advisers Act Rel. No. 1140 (Sept. 16, 1988).
(Footnote continued)

the Commission submitted legislation that would have created an SRO for investment advisers.[71] The latter two initiatives met with significant industry opposition and were never enacted.

These initiatives on the part of the Commission have been unsuccessful in narrowing the gap between the number of registered advisers and the Commission's resources. As a result, there exists a situation where, in the words of the United States General Accounting Office (GAO), "the 1940 Act may be doing more harm than good by giving investors the illusion that SEC-registered advisers have a 'seal of approval.'"[72] In addition, the Commission has no formal program to identify individuals and firms that are required but have failed to register, a problem that by its nature has been difficult to quantify but that, based on anecdotal reporting, appears to be substantial and continuing to grow.

The shortcomings of the current regulatory program for investment advisers are evident when compared with the system that has been established to govern the activities of broker-dealers. Under the Exchange Act, registered broker-dealers are required to

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70 (continued)
Larger advisers objected to the rules, arguing that they would result in more non-uniform regulation by the states. Many commentators expressed a preference for SEC regulation and expressed a willingness to pay higher fees to the Commission.

71 H.R. 3054 was introduced at the Commission's request by Chairman Dingell and several other Members.

72 GAO Report, *supra* note 62, at 3. *See also* Hearings, *supra* note 49 at 84 (statement of the Honorable Richard C. Breeden).

belong to an SRO such as the New York Stock Exchange, Inc. (NYSE) or the National Association of Securities Dealers, Inc. (NASD).[73] These SROs set qualifying standards for members and their associated persons and adopt and enforce rules designed to prevent fraudulent and manipulative practices and to promote just and equitable principles of trade.[74] Inspections are frequent and rigorous. In comparison, the Advisers Act does not require that advisers be qualified by education or experience, or meet any minimum financial requirements. Moreover, advisers do not need to meet any experience requirements or pass any tests with respect to their knowledge of the financial services industry.[75] While a rigorous examination program would mitigate the effects of these differences, the severe lack of resources to fund such a program results in the magnification of differences between these two sectors of the securities industry.

2. Fraud and Conflicts of Interest Within the Investment Adviser Industry

Financial planning and other types of investment advisory

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[73] 15 U.S.C. Section 78o(b)(8).

[74] Under SRO rules, for example, recommendations made to customers by a broker-dealer or its registered representatives must be suitable in light of the customer's financial situation and needs. See, e.g., NASD Rules of Fair Practice, Art. III, Section 2. In addition, SROs have established guidelines for the content and review of advertising materials. See, e.g., NASD Rules of Fair Practice, Art. III, Section 35.

[75] GAO Report, supra note 62, at 19.

services are in demand by consumers of all levels of income and sophistication. Advisers, including financial planners, offer a variety of services to consumers, from supervising client portfolios and selling financial products to giving advice concerning not just securities, but also insurance, taxes, real estate, and savings. The overwhelming majority of investment adviser firms are relatively small, both in terms of assets under management and number of employees. Of the total number of advisers, about 79 percent have less than $10 million under management and about 49 percent have only one employee.[76] Although clients vary from pension/profit sharing plans to banks, the most common client is an individual seeking investment advice. Because of the exponential growth in the industry and its relative lack of regulation, the opportunity for clients of all sizes and levels of sophistication to be harmed is significant.

The growth of the number of investment advisers has been accompanied by the development of new types of investment advisers that present different types of conflicts of interest than were prevalent when the Advisers Act was enacted in 1940. Traditionally, investment advisers were "money managers" who generally managed securities portfolios for clients on a day-to-day basis in accordance with mutually agreed upon investment objectives.[77] Typically, the clients of money managers were institutions or

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76 Hearings, _supra_ note 49, at 85 (statement of the Honorable Richard C. Breeden).

77 _Financial Planners Study_, _supra_ note 3, at 7.

wealthy individuals.[78]

Recent industry growth has been largely attributable to an increase in the number of "financial planners."[79] The term financial planner is not precise and includes a wide spectrum of advisory activity. However, a financial planner generally does not manage client assets; rather, the planner's primary service is to prepare a financial plan for the client, and to offer advice as to the purchase or sale of specific financial products appropriate to the implementation of the plan.[80]

One of the most serious and frequent conflicts of interest

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78 Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission pursuant to Section 30 of the Public Utility Holding Company Act of 1935: Investment Counsel, Investment Management, Investment Supervisory Services, and Investment Advisory Services at 25 (1939). More recently, many brokerages firms have implemented programs designed to make the services of traditional money managers available to clients of relatively more modest means (generally those with accounts of $100,000 or more). See, e.g., "As the Money Rolls In, Meet the 'Kings of Wrap,'" The Wall Street Journal, April 21, 1992, C-1 (describing so-called "wrap fee" programs, which offer clients brokerage and independent investment advisory services for a single fee).

79 Seventy-two percent all advisers registered with the Commission hold themselves out as financial planners, of which only a third offer money management services. Hearings, supra note 49, at 92 (statement of the Honorable Richard C. Breeden, Chairman, Securities and Exchange Commission).

80 Financial Planners Study, supra note 3, at 7. As the name connotes, the planner's function includes helping the client plan an investment strategy. If the advice given by the planner includes advice about securities, and the planner is not exempted from registration under the Advisers Act, the planner is required to register as an investment adviser. Id. at 7-8. Nothing prohibits a planner from also managing client assets.

that advisers have with clients occurs when they are compensated from commissions on the sale of investment products. Traditional money managers are usually compensated based on a percentage of assets under management, and thus generally do not face this conflict.[81] Similarly, "fee only" financial planners, who constitute a relatively small segment of the overall financial planner community, receive most of their income through the fees they charge for preparing a financial plan, do not receive any compensation in the form of commissions, and therefore also do not face this conflict.[82] However, most financial planners receive at least a portion of their income from the sale of investment products to clients.[83] This practice is not prohibited by the Advisers Act, but raises serious conflicts of interest between an adviser and its clients because the adviser has an incentive to recommend products based on the amount of commissions earned rather than on the needs of clients. Accordingly, the Advisers Act requires that such conflicts be disclosed to clients.[84]

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81 However, to the extent that the money manager executes the trade through an affiliated brokerage firm, this type of conflict may exist.

82 Financial Planners Study, supra note 3, at 59.

83 Id. A financial planner who receives commissions from the sale of securities to clients must register as a "broker" pursuant to Section 15(a) of the Exchange Act, and would be regulated under that Act as a broker-dealer in addition to being regulated as an investment adviser.

84 In a number of cases, the Commission has found that an adviser violated Section 206, and, in some cases, Section 10(b) and Rule 10b-5 of the Exchange Act, by failing to disclose the receipt of commissions from the sale of recommended investments. See, e.g., In re Westmark Financial Services, Corp., Investment Advisers Act
(Footnote continued)

Generally, clients of fee-only financial planners implement their financial plans through other firms such as securities brokers and insurance agents. Commissioned planners argue that their customers benefit from the convenience of "one-stop shopping" and would, in any event, have to pay a commission no matter where the products were purchased. There remains, however, the possibility that the products that commission-based planners advise their clients to buy may not be the most suitable or most competitively priced.

According to a study conducted by NASAA in 1988,[85] the financial planning industry has a number of significant problems. The study revealed two major problem areas: 1) fraud committed by financial planners operating outside of the regulatory system; and 2) "abusive practices," such as purely product-driven planners and advisers, unqualified planners or advisers, and a lack of proper disclosure about conflicts of interest, qualifications, and

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84 (continued)
Rel. No. 1117 (May 16, 1988); In re Halford-Smith Associates, Inc., Investment Advisers Act Rel. No. 1261 (Nov. 29, 1990). Failure to disclose compensation in the brochure and Form ADV has also been found to violate Section 204 of the Advisers Act and Rule 204-3 thereunder, as well as Section 207 of the Advisers Act, which prohibits the filing of false and misleading information with the Commission. See In re John S. LaLonde, Investment Advisers Act Rel. No. 1103 (Jan. 25, 1988). The Commission has also described this duty in no-action letters. See, e.g., Robert Cashmore Associates (pub. avail. Sept. 28, 1983); Don P. Matheson (pub. avail. Sept. 1, 1976); Investment Counseling Licensing (pub. avail. July 27, 1973).

85 See North American Securities Administrators Association, Survey of Fraud and Abuse in the Financial Planning Industry (July 26, 1988).

disciplinary history.

The problems of the first variety can be addressed in several ways, including more inspections and enforcement activities to deregister advisers engaged in fraudulent practices, better efforts to identify and either put out of business or require registration of unregistered planners and advisers, and requiring that advisers obtain a fidelity bond, which can serve to supply a pool of money for the restitution of clients' funds, while providing another source of scrutiny -- bonding companies -- of the activities of investment advisers.

The second category of problems can be addressed by increased frequency of inspections and better disclosure requirements. Investors who seek the counsel of financial professionals do so in the expectation that they will receive unbiased, objective investment advice. Increasingly, as interest rates on bank products like certificates of deposit decline, small investors will look to the securities markets as a means of investing their savings. The tremendous growth in the advisory industry can only be expected to continue.

Some of the more egregious abuses associated with the investment advisory industry are highlighted by a recent case involving a California investment adviser, Steven Wymer, who managed over $1 billion for more than 60 states and local government entities.[86] Wymer, through his company, Institutional

Treasury Management (ITM), had a total of 79 clients, of which 12 were financial institutions and 6 were pools of funds (like the Iowa Trust, a pool of numerous local Iowa municipalities) whose participants numbered approximately 250. On January 2, 1992, Wymer was indicted on 30 counts of securities fraud, mail fraud, money laundering, making false statements to Commission staff and obstruction of justice.[87] The Commission discovered the problems during a "cause" inspection that was made as a result of an unrelated tip about the trading of options on Treasury securities. Mr. Wymer is accused of selling services by promising large, risk-free gains and, when the investments failed to achieve these gains, of engaging in fictitious trades and mailing false confirmations and monthly statements to clients showing considerable gains. To fund the fictitious gains, client withdrawals, and his fees, Wymer is charged with moving assets, "Ponzi" fashion, from accounts of other clients. According to the Commission, this scheme resulted in losses to Wymer's clients of more than $100,000,000.[88]

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86 See "Iowa Funds Are Frozen In Inquiry: Fraud Case Prompts S.E.C. Rule Review," New York Times, Dec. 14, 1991, at D1. See also "Regulating Advisers: Big Securities Fraud Case in Iowa Spurring Move For More Oversight," New York Times, Dec. 16, 1991, at D1.

87 Hearings, supra note 49, at 98, note 7 (statement of the Honorable Richard C. Breeden, Chairman, Securities and Exchange Commission), citing United States v. Steven D. Wymer, No. CR 92-2 (C.D. Cal.). On April 27, 1992, the Commission revoked the registration of Wymer's two investment advisory firms. Investment Advisers Act Rel. No. 1309 (April 27, 1992).

88 Hearings, supra note 49, at 19 (statement of the Honorable Richard C. Breeden).

Another recent case involved Randall C. Hutchens (Hutchens), an Orange County, California investment adviser registered with the Commission, and his company, Laguna Equities, Inc. (Laguna).[89] On June 25, 1992, based on a Commission complaint, a federal district court entered a temporary restraining order, an asset freeze, an order prohibiting the transfer of assets and the destruction of documents, and other relief against Hutchens and Laguna. The Commission's complaint alleged that from at least January 1992, Hutchens and Laguna engaged in a fraudulent scheme involving the offer and sale of nonexistent securities known as "secured collateralized notes." The defendants may have misappropriated an amount approaching $1 million from investors. The litigation is still ongoing.

In another proceeding, In re Westmark Financial Services, Corp.,[90] a registered investment adviser consented to the entry of a Commission order finding that the respondents had breached fiduciary duties owed to their clients by failing to disclose that they would receive brokerage commissions for sale of certain securities recommended to be purchased by their clients and that the clients could purchase the securities from other unaffiliated broker-dealers, and by recommending securities unsuitable for their clients' investment needs and circumstances. As sanctions,

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89 Securities and Exchange Commission v. Randall C. Hutchens, and Laguna Equities, Inc., Civil Action No. 92-3792 RMT (CTx) (C.D. Cal.), SEC Litigation Rel. No. 13289 (June 30, 1992).

90 Supra note 84.

Westmark was censured and the principal was suspended from association with any broker, dealer, municipal securities dealer, investment company, or investment adviser for a period of 120 days.[91]

3. 1990 GAO Analysis and Recommendations to Address Shortcomings in Current Law

In a report released in June 1990, the GAO found that current Commission oversight of investment advisers provides investors little assurance that the information about qualifications and other matters they receive from advisers is accurate or that advisers operate in accordance with the requirements of the Advisers Act and Commission regulations.[92] As noted above, it was the GAO's belief that "[i]f the oversight program is not improved, the 1940 act may be doing more harm than good by giving investors the illusion that SEC-registered advisers have a 'seal of approval.'"[93]

The GAO made several recommendations to improve the oversight of investment advisers as well as the Commission's examination program. First, the GAO recommended that the Commission conduct initial inspections for each new registrant within a reasonable

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91 In re Westmark Financial Services, Corp., supra note 84.

92 See GAO Report, supra note 62. See also Financial Planners Study, supra note 3.

93 GAO Report, supra note 62, at 3.

amount of time, such as one year after registration.[94] Second, the GAO urged that the Commission conduct follow-up inspections, whenever deficiencies that present high risks to clients are noted, to verify compliance.[95] Third, the GAO concluded that the Commission should conduct periodic investigations to identify unregistered advisers and planners.[96]

CONCLUSION

Investment advisers are, perhaps, the least regulated segment of the securities industry. Severe underfunding of examination programs at the federal level, coupled with the explosive growth of the industry, have resulted in a regulated industry that is inadequately supervised.

The nature of abuses in the industry suggests that, in addition to increased funding to improve examinations, other supplemental reforms are also necessary in order to protect investors adequately. Investors, who expect the provision of unbiased and objective investment advice, are entitled to full and fair disclosure so that they can ascertain whether that is indeed the case. They are also entitled to confidence that the adviser with whom they are dealing is, in fact, registered with the

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94 Id. at 35

95 Id.

96 Id.

Commission (unless entitled to an exemption), and will make only recommendations that are suitable to their needs and financial circumstances. H.R. 5726 would accomplish these goals by providing for, in addition to enhanced funding, a number of substantive regulatory reforms aimed at better protecting investors against unscrupulous investment advisers.

HEARINGS

The Committee's Subcommittee on Telecommunications and Finance held two days of hearings on a Discussion Draft for H.R. 5726 on June 4 and 10, 1992, and held a hearing on predecessor bills, H.R. 4441 and H.R. 3054, on July 18, 1990. Testimony was received from 28 witnesses representing 23 organizations, with additional material submitted by 4 organizations.

On July 18, 1990 the Subcommittee held a hearing on H.R. 4441 and H.R. 3054, and issues related to the regulation of financial planners and investment advisers, and received testimony from: John T. Blankinship, Institute of Certified Financial Planners; Lewis Brothers, North American Securities Administrators Association; William J. Goldberg, American Institute of Certified Public Accountants, Robert A. Hewitt, International Association of Financial Planners; Mary Malgoire, National Association of Personal Financial Advisers; Blaine McReynolds, Commissioner, Tennessee Department of Commerce and Industry; Joseph P. Rath, on behalf of the American Council of Life Insurance; Barbara Roper, Consumer Federation of America; and The Honorable Mary L. Schapiro, Commissioner, Securities and Exchange Commission.

On June 4, 1992, the Subcommittee held a hearing on reform of the investment adviser industry and received testimony from Ellyn Brown, Securities Commissioner, State of Maryland; Michael Burnett,

General Accounting Office; Mary Calhoun, Calhoun Consulting Group; Richard L. Fogel, General Accounting Office; Scott Harshbarger, Attorney General, Commonwealth of Massachusetts; Monty Kincaid, General Accounting Office; Constance Menelly, investor; Edward Parks, investor; Laura Smith, investor; and Michael J. Williams, Treasurer, City of Colton, CA.

On June 10, 1992, the Subcommittee held a hearing on the Discussion Draft for H.R. 5726 and received testimony from: Donna Barwick, on behalf of the American Bar Association; the Honorable Richard C. Breeden, Chairman, Securities Exchange Commission; Lewis W. Brothers, North American Securities Administrators Association; Matthew P. Fink, Investment Company Institute; Charles R. Kowal, American Institute of Certified Public Accountants; Mary Malgoire, National Association of Personal Financial Advisors; Madeline I. Noveck, Institute of Certified Financial Planners; Robert J. Oberst, International Association for Financial Planning; Edward I. O'Brien, Securities Industry Association; Edward Parks, investor; Keith J. Rudolf, Investment Counsel Association of America; and Linda Sheimo, on behalf of the Government Finance Officers Association.

COMMITTEE CONSIDERATION

On July 30, 1992, the Subcommittee on Telecommunications and Finance met in open session and ordered reported the Committee Print as amended, by a voice vote, a quorum being present. On August 4, 1992, the Committee met in open session and ordered reported the bill H.R. 5726 with amendment by voice vote, a quorum being present.

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 2(1)(3)(A) of Rule XI of the Rules of the House of Representatives, the Subcommittee held oversight hearings and made findings that are reflected in the legislative report.

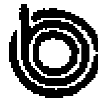
COMMITTEE ON GOVERNMENT OPERATIONS

Pursuant to clause 2(1)(3)(D) of rule XI of the Rules of the House of Representatives, no oversight findings have been submitted to the Committee by the Committee on Government Operations.

COMMITTEE COST ESTIMATE

In compliance with clause 7(a) of rule XIII of the Rules of the House of Representatives, the Committee believes that implementation of H.R. 5726 would have no significant net cost to the federal government.

CONGRESSIONAL BUDGET OFFICE ESTIMATE



CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Robert D. Reischauer
Director

September 15, 1992

Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The Congressional Budget Office has reviewed H.R. 5726, the Investment Adviser Regulatory Enhancement and Disclosure Act of 1992, as ordered reported by the House Committee on Energy and Commerce on August 3, 1992. Implementation of H.R. 5726 would have no significant net cost to the federal government.

H.R. 5726 would authorize the Securities and Exchange Commission (SEC) to collect fees to cover costs associated with the regulation of investment advisers, and would establish a schedule of fees for this purpose. The fees would be collected and be made available for spending only to the extent provided in advance in appropriation acts. The bill would require the SEC to establish a schedule for the regular inspection of investment advisers. It would allow the SEC to permit self-regulatory organizations to regulate investment advisers within their membership and to collect fees to offset costs. The bill would prohibit certain practices by investment advisers and would require them to provide certain information to clients and prospective clients. It also would permit the SEC to designate a third party to receive filings from investment advisers. Finally, it would require a number of studies, reports, and rulemakings.

Based on information from the SEC, we estimate that implementing the provisions of H.R. 5726 would result in no significant net cost to the federal government, because costs associated with the SEC's increased regulatory activities would be offset by registration fees from investment advisers. The costs, and the associated offsetting collections, could total as much as $16 million a year. The amounts of the costs and collections would depend on how much regulatory activity the SEC would delegate and on how much would be appropriated for SEC activities.

Enactment of H.R. 5726 would not affect direct spending or receipts. Therefore, pay-as-you-go procedures would not apply to the bill. State and local governments would incur no costs as a result of enactment of this bill.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is John Webb, who can be reached at 226-2860.

Sincerely,

Robert D. Reischauer
Director

cc: Honorable Norman F. Lent
Ranking Minority Member

INFLATIONARY IMPACT STATEMENT

Pursuant to clause 2(1)(4) of rule XI of the Rules of the House of Representatives, the Committee makes the following statement with regard to the inflationary impact of the reported bill: H.R. 5726 will have no inflationary impact.

SECTION-BY-SECTION ANALYSIS

Section-by-Section Analysis
"Investment Adviser Regulatory Enhancement and Disclosure Act of 1992"

Section 1. SHORT TITLE

This section sets forth the short title of the Act, the "Investment Adviser Regulatory Enhancement and Disclosure Act of 1992".

Section 2. ADDITIONAL RESOURCES FOR INVESTMENT ADVISER SUPERVISION

This section amends the Investment Advisers Act of 1940 ("Advisers Act") by adding new Section 203A, requiring investment advisers to pay, upon application for registration and annually thereafter, a fee based upon assets under management.

Subsection (a). In General. This subsection of new Section 203A provides that the Commission shall collect fees to recover the costs of registration and supervision of investment advisers. In addition, such fees are to be used for surveys of persons registered or required to be registered under the Advisers Act. The fees are to be collected and made available only to the extent provided in advance in appropriations Acts. Appropriations Acts

may only authorize the collection of fees in any fiscal year if the amount appropriated by such Act equals or exceeds the aggregate amount that may reasonably be expected to be collected by such fees. These fees will be deposited as an offsetting collection to the Commission's appropriation and will remain available to the Commission for the succeeding fiscal year.

The Committee drafted this provision with reference to the January 15, 1991 guidance from the Chair on distinguishing between user fees and taxes.[97] Consistent with that guidance and with discussions with staff from the Committee on Ways & Means, the language of the provision is intended to reflect the following principles: (1) that fees assessed and collected by the Commission are not intended to exceed the costs of regulation; (2) that only a specified list of regulatory activities are to be funded with the use of such fees; (3) that those subject to payment of the fees include only those directly subject to the regulatory jurisdiction of the Commission; and (4) that each person's fees are reasonably based upon the degree of regulatory effort that must be expended to regulate such person.

Thus, for example, if the Commission were to amass a series of fee overages over the course of several years in excess of the costs of regulation, there could be a violation of the first of

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97 See Jurisdictional Concepts Related to Clause 5(b) of Rule XXI, Congressional Record, Vol. 137, No. 10, p. H507 (Jan. 15, 1991).

these principles. Accordingly, this subsection provides that the fees collected will remain available for the enumerated purposes only for the succeeding fiscal year. It is not anticipated that an overage will be a common occurrence, both because the Commission will endeavor to predict in advance as closely as possible what its regulatory needs will be, and also because its regulatory program can be amended to absorb additional fees by, for example, increasing the frequency of examinations.

In addition, this provision was drafted in a way that encourages coordination with the appropriations process. It is anticipated that the authority to collect the fees will be adopted annually as part of legislation appropriating funds for the Commission. To facilitate the appropriations process, it is anticipated that the Commission will, annually, make reasonable projections as to both the amount of fees it is likely to collect, based upon current and anticipated registrants, and the costs of registration, examinations, and surveys. This information should assist the appropriating Committees of Congress in establishing levels of appropriations that reasonably reflect both the fee expectations and the funding needs of the Commission.

Subsection (b). Time for Payment. Paragraph (1) of new Section 203A(b) provides that when an investment adviser files an application for registration under the Advisers Act, the applicant must pay to the Commission a fee, no part of which will be refunded. If the applicant does not remit the fee together with

the application, the filing of the application will not be deemed to have taken place.

Paragraph (2) of new Section 203A(b) requires each investment adviser whose application is effective on the last day of its fiscal year to pay to the Commission a fee. The fee must be paid and received by the Commission within the following 90 days, or such period of time as the Commission may designate by rule. No part of this fee will be refunded. Payment of the annual fee is not required if the adviser's registration has been withdrawn, cancelled, or revoked prior to that date.

Subsection (c). Cost-Based Schedule of Fees. This subsection of new Section 203A sets out the amount of the fee to be paid, regardless of whether the adviser is applying initially for registration or remitting the fee required to be paid annually thereafter. The fee is to be calculated according to the following schedule, which is also contained in new Section 203A and which was generated on the basis of an estimate of the costs of the Commission's adviser regulation program, including an estimate of the costs of performing periodic inspections (ranging from once every three years to once every five years) of advisers having different amounts of assets under management:[98]

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[98] Hearings, supra note 49, at 100-02 (testimony of the Honorable Richard C. Breeden, Chairman, Securities and Exchange Commission).

Assets Under Management	Fee Due
Less than $10,000,000 ....$	300
$10,000,000 or more, but less than $25,000,000	500
$25,000,000 or more, but less than $50,000,000	1,000
$50,000,000 or more, but less than $100,000,000	2,500
$100,000,000 or more, but less than $250,000,000 ...	4,000
$250,000,000 or more, but less than $500,000,000 ...	5,000
$500,000,000 or more	7,000

In order to implement this provision, the Committee expects the Commission to adopt a rule defining the term "assets under management." In developing the fee schedule for the Committee, the Commission relied on data compiled from Form ADV filings made by investment advisers which are required to set forth the market value of accounts managed by the adviser on a discretionary and nondiscretionary basis.[99] The Committee expects the Commission rules to limit the term to assets under actual management and would not, for example, include the entire net worth of financial planner clients simply because the plans take into consideration all of the assets of the client.

The Commission projects that this fee schedule will yield approximately $16 million in additional funds for the designated regulatory purposes. As the number of registered advisers

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[99] Questions 18 and 19 of Part I of Form ADV, supra note 9.

fluctuates, the fees assessed and collected will also fluctuate, with more advisers generating more funds available for their registration and examination and with fewer advisers generating less funds but also making commensurately fewer regulatory demands on the Commission.

Subsection (d). Adjustment of Fees. This subsection of new Section 203A gives the Commission the authority to adjust the initial and annual fees by reference to the percentage change in the Consumer Price Index-U.S. City Average-All Items-All Urban Consumers, or a similar index that the Bureau of Labor Statistics of the U.S. Department of Labor may designate as its successor. The adjustment will reflect the percentage change in the index from the end of the month prior to the enactment of this section to the latest date for which the index is available.

While this provision allows for adjustments to the fee schedule over time, it is intended to address only cost increases related to more general economic and cost trends. If the Commission determines that the fees assessed and collected are insufficient or excessive to fund its regulatory program for reasons other than such cost changes, the Commission must apply to Congress for revisions to the statutory fee schedule.

Subsection (e). Suspension for Failure to Pay. This subsection of new Section 203A gives the Commission authority to suspend the registration of any investment adviser if it finds,

after notice, that the adviser has not paid when due any fee required by Section 203A. The Commission is required to reinstate the adviser's registration after the adviser pays all fees (and any penalties) due, if such suspension was based solely on the failure to pay the fee. The Commission has broad rulemaking authority to establish procedures to implement these provisions, consistent with the need for fair administration of this provision to effectuate its statutory purpose. For example, the Commission could adopt rules designed to minimize any adverse impact on clients due to such a suspension. Under certain circumstances, for example, it may be appropriate to allow a suspended adviser, prior to reinstatement upon payment of fees, to continue to provide advisory services for no compensation, until such reinstatement occurs.

Subsection (f). Rulemaking. This subsection of new Section 203A gives the Commission broad authority to adopt rules as necessary to carry out the purposes of Section 203A.

Subsection (b) of Section 2 of the bill provides that new Section 203A shall become effective upon adoption of the rules under Section 203A(f).

Section 3. EXAMINATIONS AND SURVEYS

This section amends the Advisers Act by adding new Section 223 which provides for the conduct of examinations and surveys.

Subsection (a). Periodic Examinations. This subsection of new Section 223 requires the Commission to establish and periodically revise a schedule for the regular examination of investment advisers. This schedule should be designed to provide for more frequent examinations of certain investment advisers based on factors that increase the need for examinations of those advisers. Because the relative importance of such risk factors may change over time, the schedule should be revised periodically to take into account any such changes. Further, it is not intended that such schedule be made public, but rather that the Commission use it internally as part of its examination program to target advisers with the highest risk profiles for the most frequent examinations.

Examples of factors that would dictate more frequent examinations are the frequency and nature of customer complaints, custody of funds and authority to exercise investment discretion, and receipt of commissions for the sale of investments recommended to clients. This list is not, however, exclusive, and it is intended to be supplemented, as appropriate, by the Commission.

In its June 1990 report to Congress,[100] and again in testimony before the Subcommittee on Telecommunications and Finance,[101] the

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100 See GAO Report, supra note 62.

101 See Hearings, supra note 49, at 24-25 (response of Richard L. Fogel, Assistant Comptroller General, General Government Programs, General Accounting Office, to a question from Congressman Boucher).

GAO expressed the view that a comprehensive and effective examination program must be predicated upon risk.[102] In particular, the GAO argued that the Commission could do a better job of collecting and using information from examination results to help identify for more frequent examination those advisers representing the most significant risk to investors.[103] The Commission has expressed the view that size is an important factor, given the damage that can be done to a large number of investors, the reputation of the advisory industry and to the markets generally, if a large adviser is engaged in fraudulent practices resulting in losses to clients.[104] The GAO, however, has emphasized that size, the risk factor most frequently used by the Commission in determining which entities to examine, was not necessarily a good indicator of the likelihood of harm to the investor.[105]

The examination schedule should target (1) more new investment advisers for examination within approximately one year of registration to check for adequate compliance procedures, taking into account the level of risk presented by advisers' activities and (2)

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102 GAO Report, supra note 62, at 19, 20.

103 Id.

104 Id. See also Hearings, supra note 49, at 129 (response of the Honorable Richard C. Breeden, Chairman, Securities and Exchange Commission, to a question from Congressman Scheuer).

105 Hearings, supra note 49, at 29 (GAO response to question from Chairman Markey). The GAO also noted that such apparently irrelevant factors as an adviser's geographical location might, upon statistical analysis, be found to be relevant.

follow-up examinations of investment advisers found to have deficiencies that may continue to present high risks to their clients.

The GAO, both in its 1990 report and in its 1992 testimony, argued forcefully that examinations of new registrants be conducted within a reasonable period of time following registration. In particular, because registration information is not verified by the Commission except during examinations, an early examination is useful in detecting whether inaccurate information (about an adviser's background, business practices, or conflicts of interest, for example) is being distributed to investors. The earlier such inaccuracies are corrected, and the earlier problems with internal controls or books and records come to light, the greater the likelihood that they can be corrected with minimal damage to advisory clients.[106]

Of equal concern to the GAO was the Commission's practice of relying on the adviser's word that a deficiency noted during an examination had been corrected. The GAO noted that even when serious defects exist, including breaches of fiduciary obligations or a failure to disclose conflicts of interest, there is often reliance on the adviser himself to certify correction of the problem.[107] Accordingly, the GAO strongly advocated follow-up

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[106] GAO Report, _supra_ note 62, at 16, 17.

[107] _Id_. at 22.

examinations by the Commission when deficiencies that present significant risks to clients are found.[108]

While the Commission clearly requires substantial latitude in conducting its examination program in the manner it deems appropriate, the Committee believes that it is important that certain key elements of an effective examination program, such as early examinations of new registrants whose activities present a high level of risk to their clients, follow-ups where significant deficiencies are found, and risk-based examinations be present in some form. To provide the Commission additional flexibility in meeting the requirements of this paragraph, however, the Committee requires the Commission to target examinations within _approximately_ one year following initial registration, taking into account the level of risk presented by the adviser's activities, and follow-up examinations only where deficiencies are found that may continue to present _high risks_ to clients. The Committee has built in such measured flexibility because it understands that if the Commission were to inspect all new advisers within their first year of registration and reinspect all advisers for which deficiencies have been found to exist, the examination cycle for other advisers might be lengthened substantially. Thus, in developing its schedule, the Commission should weigh carefully the impact on these other advisers and their clients, but must keep in mind that it is a goal of the legislation that new advisers be given increased

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108 GAO Report, _supra_ note 62, at 35.

attention in the Commission's inspection program. If funding is inadequate to implement properly the provisions of the Act, the Committee expects the Commission to request additional funding rather than routinely to fail to meet the examination goals contained in the Act.

Subsection (b). Surveys of Unregistered Persons. This subsection of new Section 223 requires the Commission to conduct periodic surveys to determine the extent of, and reasons for, the failure of persons to register as required by the Advisers Act. The Commission must prepare and implement a plan to reduce or eliminate such failures and report to Congress in its annual report on its progress in such implementation. If the survey identifies any pattern of misinterpretation of the definition of investment adviser as the basis for the failure to register, the Commission's plan must include such rulemaking proceedings as may be required to correct such misinterpretation.

The Committee intends that this survey be conducted as rigorously as possible and with methodology designed to reflect as accurately as possible the magnitude of the problem posed by unregistered advisers. While the Committee understands that it is difficult, if not impossible, on a cost-effective basis to identify every unregistered investment adviser, it also believes that any widespread failure to register has significant implications for both the law-abiding segment of the industry and the investor. It is of particular importance that those who fail to register be

confronted with appropriate Commission action, whether in the form of civil penalties, orders to cease and desist, or other enforcement proceedings.

Only those who provide advice on securities investments are required to register under the Act. With respect to those that do provide such advice, there exist several exceptions from the definition of "investment adviser" as, for example, with a lawyer, accountant, engineer, or teacher whose performance of investment advisory services "is solely incidental to the practice of his profession."[109] Despite the fact that the law is clear with respect to both who must register and who is entitled to the exceptions from the definition, there appears to be a growing number of unregistered advisers.[110] While no definitive statistics exist with regard to the precise magnitude of the problem, the GAO has recommended that the Commission incorporate into its examination program a means of identifying unregistered advisers. Not only are there competitive implications when unregistered advisers are allowed to compete with those that are regulated, but investors are ill-served when they are denied the protections of the Advisers Act. This problem can only be expected to increase as registration fees are increased and annually assessed and as

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109 15 U.S.C. Section 80b-2(a)(11)(B).

110 The GAO cites a 1988 figure provided by the International Association of Financial Planning of between 100,000 and 300,000 financial planners nationwide, of which only about 17,000 are registered as investment advisers. See GAO Report, supra note 62, at 18. The GAO has not independently verified this estimate.

obligations under the Advisers Act are expanded.

Compounding the problem of those advisers who either willfully fail to register or are unaware that they must do so is the problem of those who rely inappropriately on the exceptions contained in the Act. Currently, the Commission has outstanding a staff interpretation, issued by the Commission as Release No. 1092 that, among other things, clarifies the scope of the "solely incidental" exclusion under the Act.[111] In particular, Release 1092 establishes that accountants, attorneys, teachers or engineers who "hold themselves out" as financial planners, investment advisers, pension consultants or similar terms and who in fact give investment advice will not be deemed to be providing that advice "solely incidental" to their other professional activities. While the Committee contemplated including in the bill a provision requiring the Commission to, in effect, codify this interpretation so that there could be no possible confusion about it, the Commission opposed such a required rulemaking, on the grounds that the Commission both had the authority to engage in such a rulemaking under current law and saw no reason to exercise it because the law -- and its interpretation -- were clear. Commission Chairman Breeden testified that this interpretation was "put out with the express concurrence of the Commission itself. ... In our testimony, indeed, we suggest that, rather than more rulemakings to redefine what the Commission has already defined,

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[111] Supra note 2 at notes 11-16 and accompanying text.

the better activity would be to bring some enforcement actions."[112]

The Committee thus has determined that it is appropriate to support the Commission's interpretation of the "solely incidental" exclusion as contained in Release 1092 and expects that, as part of its obligations under this subsection to conduct surveys of unregistered advisers and to correct any patterns of misinterpretation about who must register, the Commission will seek vigorously to enforce the terms of Release 1092.

Section 4. DESIGNATION OF SELF-REGULATORY ORGANIZATIONS

This section creates a new Section 224, designed to permit the Commission to delegate to SROs the examination responsibility for the investment advisory activities of their members and affiliates of their members, but not those members (or their affiliates) whose primary business is providing investment advisory services. The ability of the Commission to designate an SRO for this purpose provides the Commission with greater flexibility in responding to large growth in the population of investment advisers; allows for more efficient performance of examinations, since SRO examiners may already be in the field to examine the broker-dealer aspect of the investment adviser; avoids duplicative SRO and Commission examinations of SRO members whose registered representatives also act as registered investment advisers; preserves the securities laws'

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112 Hearings, supra note 49, at 113 (statement of the Honorable Richard C. Breeden).

successful utilization of self-regulation in lieu of direct government regulation where appropriate, particularly as broker-dealer and investment adviser activities increasingly converge; and would permit industry committees to participate in the self-regulatory process to deal with the policy and legal issues of investment adviser regulation. The Commission has full discretion and flexibility in exercising its delegation authority under this provision, including specifying, or placing limits on, the scope and frequency of examinations undertaken by an SRO and defining the penalties that an SRO may impose (subject to the limitations on penalties contained in new Section 224).

Subsection (a). Designation to Conduct Examinations. Subsection (a) of new Section 224 permits the Commission, by rule, and consistent with the public interest, the protection of investors, and the purposes of the Advisers Act, to designate one or more SROs registered as such with the Commission to conduct periodic examinations of SRO members and their affiliates to determine compliance with the Advisers Act and rules thereunder. Each designated SRO, by virtue of its authority over member broker-dealers and their associated persons under the Exchange Act, will thus be explicitly authorized to inspect and discipline its members and their affiliates for violations of the Advisers Act and the rules thereunder pursuant to standards and procedures set forth in Sections 6, 15A, and 19 of the Exchange Act.[113] Section 224(a)

[113] 15 U.S.C. Sections 78(f), 78o-3, and 78s. SROs already have
(Footnote continued)

provides that any penalties imposed by an SRO may not exceed those contained in subsections (e), (f), and (i) of Section 203 of the Act. The specific penalty provisions of new Section 224 are consistent with the types of penalties imposed by SROs. The purpose of the inclusion of subsection 203(i) is to limit the monetary penalties to be imposed by an SRO to the maximum amounts specified in that subsection.

The Committee intends that any registered investment adviser, for whom examination authority is delegated to an SRO under this provision, shall have the full appeal rights to the Commission of an SRO disciplinary action that is afforded to any member or person associated with a member under the Exchange Act. It is expected that the designated SRO will make the appropriate modifications to its by-laws and rules to conform those by-laws and rules with the new statutory requirements.

In determining the public interest, the protection of investors, and the purposes of the Act, the Commission should take into account, among other factors, whether the SRO to be designated has the capacity and expertise to assume the regulatory responsibilities required of it. In particular, the Commission should

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113 (continued)
authority over "associated persons" of their members pursuant to the Exchange Act. The term "affiliate" in subsection (e) of the section would include some of the same entities that are "associated persons" of SRO members, as that term is defined in Section 3(a)(21) of the Exchange Act. 15 U.S.C. Section 78c(a)(21).

review the adequacy of the personnel to be committed, in terms of quantity, training, and experience. The Committee expects that no such designation will occur until the Commission is satisfied that the SRO is capable of conducting examinations at least as thoroughly as the Commission could do so itself. In addition, the Committee expects that the Commission will necessarily need to obtain some experience with its own enhanced inspection program before such designation would occur.

Subsection (b). Limitation. Subsection (b) of new Section 224 prohibits the Commission from authorizing an SRO to conduct examinations of members and their affiliates pursuant to this section if the primary business of the member and its affiliates is investment advisory activities. The Commission may establish criteria for defining the term "primary business". In addition, the Commission could limit an SRO's inspection of other types of broker-dealer affiliated investment advisers. For example, since the Commission inspects an adviser to an investment company at the same time it inspects the investment company, it may wish to retain inspection responsibility over investment company advisers.

Subsection (c). Authority to Impose Fees. Subsection (c) of new Section 224 allows an SRO designated by the Commission to conduct examinations to collect fees in amounts determined in accordance with Commission rules. Such rules must require such fees to (A) cover only the costs of the SRO's expenses for examinations; (B) bear a reasonable relationship to the costs of

conducting an examination of a particular adviser; and (C) not exceed the portion of the fee that would otherwise be payable to the Commission that is allocable for conducting such an examination. The fees that would be charged by the SRO to its members for these activities would be limited so that the investment adviser would not have to pay an amount that is more than it would have to pay if the Commission inspected it. The Committee understands that examinations will vary by investment adviser depending on a wide variety of factors, including the complexity of the activities engaged in, quality of recordkeeping and apparent regulatory deficiencies. As a result, there will be some examinations that take longer or shorter than other examinations for investment advisers within that level of the fee schedule. Accordingly, the Committee recognizes that costs will be assigned to class or category of investment adviser.

For purposes of its rulemaking pursuant to this subsection, the Commission may designate categories of investment advisers for which each of the above three standards generally obtains. Even if an investment adviser is required to pay a fee to an SRO under this section, the adviser must also pay a fee to the Commission. This latter fee is the annual fee set forth in Section 203A, less the amount it is required to pay to the SRO. Thus, registrants will pay, in the aggregate, the applicable amount set forth in the fee schedule in Section 2 of this legislation, regardless of whether an SRO or the Commission conducts the adviser's examinations.

The same principles set forth with respect to the general fee provisions in the Act relating to concerns expressed by the Committee on Ways & Means obtain in this context as well: the aggregate fees assessed and collected by the Commission and the SRO are not intended to exceed the costs of regulation; such fees are to be devoted exclusively to an enumerated list of regulatory activities; only those persons directly subject to the regulatory jurisdiction of the Commission are covered; and each registrant's fees are reasonably based on the regulatory effort expected to be focused on it.

Subsection (d). Effective Date of Rule. Subsection (d) of new Section 224 provides that Commission rules under this section will not go into effect until 90 days after the date on which the Commission submits to Congress a report (1) containing the text of the proposed rule and the reasons for it; (2) describing the procedures to be used to coordinate the collection of fees by the Commission and the SRO; and (3) containing any needed additional information. This delay of the rule's effective date is needed in order for proper coordination between the Commission, its authorizing Committees, and the appropriations Committees to occur prior to SRO fee collection activities.

Subsection (e). Definition. Subsection (e) of new Section 224 defines the term "affiliate" for purposes of this section.

Section 5. SUITABILITY AND OTHER ADVISER OBLIGATIONS

Section 5(a). Amendment. In addition to the substantive changes described below, this section reorganizes Section 206(1)-(4), without any modification to the substance of those provisions. New subsections (a)(1) through (a)(4) and (b)(1) and (b)(2) are intended to have the same substantive content as before and to preserve, without change, the existing law. Section 5 also adds two substantive provisions to Section 206 intended to codify existing law. New Section 206(5) would make explicit the adviser's duty to make only suitable recommendations to its clients. New Section 206(6) would prohibit an adviser from guaranteeing that a specific result will be achieved as a result of following investment advice.

A. Suitability

1. General Section 5 amends Section 206 of the Advisers Act by adding a new Section 206(5) expressly prohibiting advisers from making unsuitable recommendations and a requirement to make a reasonable inquiry about the financial circumstances of a client. A suitability requirement is currently implicit in the antifraud provisions of the Advisers Act and thus new Section 206(5) would not impose an additional substantive requirement, but rather would expressly restate an existing one.

Advisers have a fiduciary relationship with their clients and are required to exercise the highest degree of care and the utmost and exclusive loyalty to clients.[114] This duty is enforceable

under the antifraud provisions of the Advisers Act, and the Commission has brought several cases against advisers giving unsuitable advice under the general antifraud provisions of the Advisers Act.[115] Because of the importance of the duty of advisers to assure that their recommendations are suitable, the Committee believes it would be desirable to make that duty explicit.[116]

2. Duty to Inquire

Under new Section 206(5), an adviser, at the commencement of the advisory relationship and periodically as appropriate thereafter, must make an inquiry into the client's financial situation, investment experience, and investment objectives. The frequency of updating the information obtained from the client will turn on what is appropriate under the circumstances and whether the adviser is aware of events that have occurred that could render the information on which it currently bases its advice obsolete. For

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114 See SEC v. Capital Gains Research Bureau, supra note 16, at 194.

115 See, e.g., In re Westmark Financial Services, supra note 84 (financial planner recommended speculative equipment leasing partnerships to unsophisticated investors with modest incomes); In re George Sein Lin, Investment Advisers Act Rel. No. 1174 (June 19, 1989) (investors desiring low-risk investments invested in uncovered option contracts).

116 Similarly, broker-dealers have suitability obligations derived from the antifraud provisions of the Exchange Act. See Clark v. John Lamula Investors, Inc., 583 F.2d 594, 600 (2d Cir. 1978). See also Securities Exchange Act Rel. No. 27018 (July 11, 1989). In addition, the SROs have specific suitability and "know your customer" rules applicable to their members. NASD Rules of Fair Practice, Art. III, Section 2; Rule 405, paragraph 2405, New York Stock Exchange Guide (CCH).

example, a change in the tax law or knowledge that the client has retired or divorced might trigger an obligation to make a new inquiry.

3. Duty to Give Only Suitable Advice

New Section 206(5)'s suitability provision prohibits an adviser from giving advice to clients unless the adviser reasonably determines that it is suitable to the client's financial situation, investment experience and investment objectives. These factors are intended to be given different weight in different circumstances. For example, in some circumstances an institutional investor such as a pension plan may hire an investment adviser to manage a portion of its assets. Having established that the client is a large institutional investor, in most circumstances, the most relevant factor in determining whether the advice rendered is suitable would be whether the advice is consistent with the institutional client's stated investment objectives.

Paragraph (B) of new Section 206(5) requires the adviser to have "reasonably determined" that the advice is suitable for the client. A reasonable determination would require, for example, that certain kinds of particularly risky products, such as direct participation programs[117] or certain CMO tranches,[118] only be recommended to those who can and are willing to tolerate the risks

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117 See, also NASD Rules of Fair Practice, paragraph 2192, Sec. 3(b)(1)(i).

involved and for whom the benefits described in the prospectus can be realized to a significant extent.

While under new Section 206(5) the adviser must reasonably determine that each piece of investment advice must be suitable for the client, the Committee intends that the suitability of advice be evaluated in the context of the client's overall portfolio.[119] For example, an adviser may hedge a portfolio of U.S. government bonds for a client having a very conservative investment approach, in which case the suitability of the hedging instruments would be evaluated in light of their hedging function.[120] Thus, inclusion of some risky securities in a portfolio of a risk-averse client may not be unsuitable.[121]

New Section 206(5)'s suitability obligation includes the requirement that an adviser "know his client," as well as the

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118 Collateralized mortgage obligations (CMOs) are bonds that are collateralized by mortgage-related instruments. Each of the group of bonds issued in a CMO issue is known as a "tranche," and each tranche will have different risk and return characteristics.

119 For an account under discretionary management, the Committee understands that each trade initiated by the adviser would constitute "advice."

120 A similar standard is applied in determining the prudence of an investment made for a retirement plan under the Employee Retirement Income Security Act of 1974 (ERISA) (See 29 C.F.R. 2550.404a-1(a), and generally in determining the suitability of a trustee's investment decision under trust law (See Restatement (Second) of Trusts, Section 227 commentary (1959)).

121 Conversely, while advice to invest in a particular security may be suitable to the needs of a client, advice to make the same investment on margin may not be.

requirement that an adviser "know his product." Lack of actual knowledge about the client or the investment products recommended will not provide a defense for an adviser unless it would be reasonable for the adviser not to have known the information.[122] It would, for example, be reasonable for an adviser to rely on information provided by a client (or its agent) regarding the client's financial circumstances, and an adviser should not be held to have given unsuitable advice if it turns out that the client has misled the adviser. However, if a client refuses to provide requested information, the adviser may not make assumptions about the client that are not reasonable.[123] Where no other information is available, this may mean assuming the client has no other assets or source of income.[124]

The Committee does not intend for the section to be inter-

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[122] See In re Alfred C. Rizzo, Investment Advisers Act Rel. No. 897 (Jan. 12, 1984) (investment adviser expected to have a reasonable basis for advice and could not rely on "incredible" claims of issuer of security).

[123] In one case, where a client turned over approximately $100,000 to a broker but refused to provide financial information, the Commission explained that the broker had a "duty to proceed with caution; to make recommendations only on the basis of the concrete information that [the client] did supply and not on the basis of guesswork as to the value of other possible assets." In re Eugene J. Erdos, Securities Exchange Act Rel. No. 20376 (Nov. 16, 1983), aff'd sub nom. Erdos v. Securities and Exchange Commission, 742 F.2d 507 (9th Cir. 1984).

[124] If the client fails to provide information upon which an adviser can base recommendations pursuant to this provision, the adviser may rely upon information about the client that it obtains from other reliable sources. Such a situation could occur where, for example, advice by a pension plan is sought through the intermediary of a pension plan consultant.

preted as requiring that knowledge of an affiliate of the adviser be attributed to the adviser if it would be unreasonable to expect the adviser to know the information. For example, Section 204A of the Advisers Act may require that advisers erect "Chinese Walls" to prevent insider trading, in which case the adviser may not have access to the information.

4. Recordkeeping

Section 5 requires advisers to make and keep such records as the Commission may reasonably require of the information obtained from its clients as a result of inquiries the adviser has made in complying with Section 5.[125] The Committee does not intend that this provision be used to require advisers to memorialize the suitability considerations behind every piece of investment advice. The Committee expects that the Commission will consider in adopting rules under this section the burdens imposed on advisers that are required to keep records as well as those records the Commission needs to determine that advisers are in compliance with these provisions.

The recordkeeping requirement contained in paragraph (5)(C) is

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125 As used in this section the term "reasonable" is intended to direct the Commission to adopt reasonable recordkeeping rules. This provision supplements Section 204 of the Act, under which the Commission is given general authority to require advisers to maintain records. The Commission would also have authority under Section 206(4) to adopt rules "reasonably designed to prevent" violation of Section 206(5).

intended to assist the Commission in determining whether investment advisers are complying with the Act's suitability requirement. It is anticipated that review of an adviser's records will constitute part of the Commission's examination protocol. The Committee also expects that, when investor complaints about breaches of an adviser's suitability obligations are filed with the Commission, records kept in compliance with this provision will facilitate Commission inquiry into such complaints.

B. No Guarantees

New paragraph (6) of Section 206(a) prohibits an investment adviser from guaranteeing that a specific result will be achieved as a result of the investment advisory services. This provision codifies existing interpretations of the Act's antifraud provisions.[126] While the investment adviser may recommend products that are themselves guaranteed by the U.S. government (as, for example, a U.S. Treasury security), and the adviser may properly describe those securities as guaranteed, the adviser himself may never guarantee specific results on any investment advice.

C. Exemptions and Special Rules.

Subsection (b) designates certain exemptions and special rules. Paragraphs (1) and (2) have been broken out from Sections

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[126] See SEC v. C. R. Richmond & Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,273 (9th Cir. 1977).

206(3) and 206(4) as previously drafted, for purposes of statutory reorganization. These amendments have no impact on the substance of those provisions.

1. Impersonal Investment Advice. The prohibition against making unsuitable recommendations would not apply to impersonal investment advice. When impersonal investment advice is provided, through a newsletter, for example, there is no expectation that the advice has been tailored to the client's needs, and it would be impractical for the adviser to ascertain the suitability of the recommendations for individual subscribers.

Paragraph (3) of subsection (b) defines impersonal advisory services, for purposes of subsection (a)(5), as any investment advisory services provided (i) by means of written material or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts; (ii) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or (iii) by any combination of the foregoing.

2. Section 5(b). Rulemaking Required. The Commission must issue the rules required under Section 206(a)(5)(C) of the Advisers Act within one year from the date of enactment of the bill.

Section 6. ADDITIONAL DISCLOSURE OBLIGATIONS OF INVESTMENT ADVISERS

Section 6(a). Additional Obligations. This section amends Section 204 of the Advisers Act by adding a new subsection (b) relating to the content and delivery of brochures. Section 6 will be satisfied by an investment adviser to an investment company upon the disclosure of the information required in this section to the investment company or its board of directors. This provision does not require an investment adviser to an investment company to disclose such information to the individual shareholders of the investment company.

Subsection (b). Brochure Required. Paragraph (1) of new Section 204(b) requires that each registered person must disseminate to each client or prospective client a document disclosing facts concerning certain matters important for the client to know before engaging an adviser. In order to provide for timely and effective disclosure of such facts and matters to clients, the Commission shall prescribe the format of the document and the timing of its dissemination.

The general intent of the brochure provision in this legislation is to codify and enhance the existing brochure obligations of investment advisers under the Commission's brochure rule.[127]

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[127] The Commission can, of course, use its exemptive authority in Section 206A of the Advisers Act to exempt from the brochure requirement certain advisers or certain advisers with respect to certain client relationships based on the standards set forth in that section, e.g., in connection with entering into an investment advisory contract with an investment company or a contract for impersonal advisory services. See 17 C.F.R. Section 275.

(Footnote continued)

Paragraph (2) of this subsection sets out the contents of the brochure. The document required to be so disseminated must include information concerning the education and business background of the adviser and of any associated person providing significant investment advisory services to the client, compensation arrangements between the client and the investment adviser, the nature of services offered (e.g., financial planning or market timing services), business practices, methods for obtaining information on disciplinary history and registration of the investment adviser and persons associated with the investment adviser, and conflicts of interest which could reasonably be expected to impair the rendering of disinterested advice (e.g., whether the adviser sells investment products that it recommends to clients). The Committee believes that an adviser may comply with this provision by a general discussion of conflicts that reasonably can be anticipated to occur in addition to conflicts the Commission specifically requires to be disclosed in its brochure rule.[128]

Paragraph (3) of subsection (b) requires prominent disclosure of the following: (A) that either the registered person receives or may receive, directly or indirectly, sales commissions or other fees in connection with a purchase or sale effected on behalf of a client, or that the registered person will not so receive any sales commission or other fees in connection with such purchase or sale,

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[127] (continued)
204-3(b)(2).

[128] See, e.g., Questions 8 and 9 of Part II of Form ADV.

but that the customer may be charged a sales commission or other fee by another person in connection with such purchase or sale; and (B) that remedies may be available to the client with respect to disputes arising out of the advisory relationship.

While prominence requires that these disclosures be highlighted relative to the other contents of the brochure, the Committee does not intend that they necessarily need to be on the first page of the brochure, or that equal prominence be given to information about conflicts of interest and about the availability of remedies. This provision simply requires that each of these disclosures must, independently, stand out and be readily noticeable to the client.

With regard to disclosure of remedies, the Committee does not intend a recitation of available causes of action but, rather, a general statement in the brochure that makes clear the existence of remedies under state and federal law where wrongs have been committed against a client by an adviser. This provision is not intended to suggest to clients that a cause of action exists for every perceived wrong, nor is it intended to create any new causes of action under the federal securities laws. However, the Committee believes that, in the absence of an express private right of action in the Act, it is especially important to inform clients that they are not without remedies.

Paragraph (4) directs the Commission to define the term

"associated person providing significant investment advisory services to the client," by rule, for purposes of this subsection. This term is used to describe those individuals whose education and business background must be profiled in the brochure. It is the intent of the Committee to capture in particular the individual or individuals with whom the client discusses his needs and objectives and who works with the client to design the advisory or financial plan. For large firms with numerous employees, it is contemplated that separate biographical supplements of the appropriate individuals can be included with each brochure.

The above disclosures are not intended to supplant, but rather to supplement Part II of Form ADV and other disclosures required under the current brochure rule. To the extent that Form ADV or other current mechanisms for disclosure satisfy the requirements of this Act, or to the extent that Part II of Form ADV can be revised to incorporate these requirements, the above provisions should be satisfied. The Committee encourages the Commission to conform the Form ADV disclosures to the brochure requirements of this legislation in order to avoid any duplicative or inconsistent disclosures.

Subsection (c). Transaction Reports. New Section 204(c) establishes requirements relating to "transaction reports." Paragraph (1) of this subsection requires each registered person, before a purchase or sale is effected on behalf of the client, to disclose to each client (A) the amount of sales commissions or

other fees that may reasonably be expected to be charged or deducted in connection with the purchase or sale, (B) that the adviser will receive such amount or a portion of such amount, or, in the case of a transaction to be effected through a broker or a dealer that is a person associated with or under common control with the adviser, that the broker or dealer is affiliated with the adviser and will receive such amount or portion of such amount,[129] and (C) the existence of any compensation arrangement with an issuer or other third party with respect to the recommended transaction. Such initial disclosure shall be in writing if the purchase or sale was recommended in writing.[130] When recommendations are made orally, transaction report information may, at that time, be transmitted orally as well.

The Commission may, by rule, permit an investment adviser to omit the pre-transaction disclosure required by this paragraph with the knowing written consent of the client. The rule could relieve

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129 An adviser that receives sales commissions or other fees charged in connection with the purchase or sale of securities on behalf of its clients generally would be required to register and be regulated as a broker-dealer under the Exchange Act. See e.g., Fundamental Advisors, Inc. (Pub. avail. Dec. 4, 1971).

130 The Committee expects that, in the case of a financial plan, when transactions are expected to shortly follow delivery of the plan, such disclosure be delivered with the plan when feasible. At the time the plan is provided to clients, the nature of the transactions and who will effect the transactions may not be known. Clients may be given options both with respect to what investment products will be bought, who will effect the transaction, and when the investment products will be bought. All of these options will affect the amount of fees and charges. It should be kept in mind, nonetheless, in implementing this requirement, that it is a goal of the legislation that clients be provided timely and effective disclosure.

all advisers, certain advisers, or advisers with respect to only certain clients, e.g., institutional investors. The written consent must be predicated upon proper and prominent disclosure by the investment adviser of the kind of information the customer would not receive as a result of such consent.

The Committee intends that information in the transaction reports will provide clients with specific information about the nature and magnitude of conflicts of interest caused by the receipt of transaction-based compensation by the adviser (or a related person) that may interfere with the provision of objective investment advice. While the brochure discloses the fact that the adviser engages in the practice of effecting securities transactions for clients,[131] the brochure cannot tell the client whether the particular transaction will result in the receipt by the adviser of compensation (whether there is a conflict) or the amount of the compensation (the magnitude of the conflict).

The Committee elected to focus this transactional disclosure on aggregate amounts to be charged or deducted and issuer or third party payments made to the adviser or associated persons or those under common control with the adviser rather than on amounts received by the investment adviser or the representative. Because the latter form of disclosure would necessarily omit amounts paid to other persons, including affiliates, compensation arrangements

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131 Item 9B of Part II of Form ADV.

could likely be altered to circumvent the disclosure. Moreover, focusing exclusively on the amount the adviser or the representative receives may mislead clients into thinking that fees or commissions are smaller than they in fact are. The Committee believes that the amounts required to be disclosed in the subsection as drafted represent a reasonable proxy for the amounts that will be allowed to the dealer or registered representative that is working with the client, and therefore is properly reflective of any bias that may exist on the part of such person. Clients that are interested in actual amounts to be retained by the various parties to the transaction, such as the broker-dealer or its representative, can inquire as to those amounts. The Committee expects that the Commission, in connection with its inspection activities, will monitor disclosures made pursuant to this subsection to ensure that they continue properly to reflect the magnitude of conflicts of interest that exist.

Subsection (c)(1) would only require advisers to disclose the amount of sales commissions or fees that may "reasonably" be charged or deducted "in connection with the purchase or sale." Thus, in some cases where the adviser cannot reasonably be expected to know the precise commission, the adviser could approximate the amount of commission or fee that the client would pay. For example, if an affiliated broker-dealer commission schedule provides for a higher level of commissions for stocks trading above a certain level, the adviser would not have violated this provision if the stock price were to rise above such level after the advice

is given but before the trade is executed, resulting in a higher commission.

It may be impracticable to disclose some _de minimis_ administrative fees and charges clients incur in connection with the transaction. The failure to disclose such fees (which may include small fees for postage, handling and transfer agency costs) would not violate this Section. In addition, the requirement is limited to fees "in connection with the purchase or sale" of a given investment product.[132] Examples include brokerage commissions or spreads, sales loads and Rule 12b-1 trail fees on mutual funds, underwriting discounts and other similar fees and charges that would be triggered by the transaction. Other fees and charges that are remote from or independent of the transaction itself would not be covered. For example, if the adviser sells a security on behalf of a client and places the proceeds in an investment company it advises, the amount of its advisory fee would not be required to be disclosed by this section.[133]

Paragraph (2) of this subsection provides that after such purchase or sale is effected, the investment adviser shall transmit to its clients a written statement that discloses the amount of

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[132] The Committee does not intend this phrase to be necessarily interpreted in the same way as the phrase is used in Section 10(b) of the Exchange Act.

[133] The adviser would, of course, be required under the general antifraud provisions of the Advisers Act to inform clients that it acts as adviser to the mutual fund for which it receives an advisory fee. _See_ AMA Advisers, Inc. (pub. avail. May 17, 1987).

sales commission and other fees that actually were charged or deducted in connection with such purchase or sale and information with respect to the existence of any compensation arrangement with an issuer or other third party with respect to the transaction.

Paragraph (3) of this subsection directs the Commission to prescribe rules governing the form and contents of the written statement required by paragraph (2). These rules, to the extent consistent with the protection of investors, should permit a confirmation statement of a broker or dealer contain the information required by this subsection to be used as the written statement required by this subsection.

Paragraph (4) of this subsection provides for certain exceptions where the subsection will not apply: (A) with respect to any purchase or sale for which the registered person, and any person associated or under common control with the registered person, will not receive any portion of the amount charged or deducted in connection with the purchase or sale, and will not receive any payment under a compensation arrangement required to be disclosed under paragraph (1)(C); (B) with respect to accounts for which the person is authorized to exercise investment discretion; or (C) with respect to any account for which the person is not acting as an investment adviser. Subparagraph (C) would not, however, exempt an adviser that claimed to have "changed hats" with respect to a particular transaction by first recommending the transaction as an adviser and then executing the transaction as a

broker.

Paragraph (5) provides for a special rule for the situation where a person (representative), usually a financial planner, associated with an investment adviser (adviser) effects client transactions through a broker-dealer with which the representative is associated but which is not affiliated with the adviser. Clients of the representative must be provided with the required disclosure concerning the commissions or other compensation that will be paid or received in connection with the transaction. The provision does not exempt the adviser in this situation from its obligation to provide the required disclosure. Nor does it exempt the adviser from responsibility for supervising its associated persons in disclosing all conflicts they may have. Paragraph (5) does not require duplicative disclosures. In most cases, the Committee expects that the obligations of both the adviser and the associated person would be satisfied when the disclosures are provided by the associated person.

Subsection (d). Periodic Reports. This subsection requires, in paragraph (1), that each registered person periodically provide to each client a written statement of the commissions and other fees paid by the client for all services provided by the registered person and any person associated with or under common control with the registered person, any amounts received directly or indirectly by the registered person or any person associated with or under common control with the registered person pursuant to any

compensation arrangement with an issuer or other third party with respect to the recommended transaction, and such other matters as the Commission shall prescribe.

Paragraph (2) of this subsection directs the Commission to establish by rule the format of the statement and the timing of its delivery, for example, on a quarterly basis. The section gives the Commission broad authority which it may flexibly exercise in implementing the provision. However, any rule must require that the format be designed to present the required information in a manner that readily permits clients to compare the costs charged by the investment adviser to the costs charged by other advisers for comparable services. In adopting its rule, the Commission must require an investment adviser whose clients purchase or sell investment products through persons other than such adviser, or persons associated or under common control with such adviser, to indicate to its clients that such information concerning costs charged does not include commissions or other fees paid in connection with such purchases or sales. The Commission is directed to permit in its rules a periodic report of a broker or dealer that contains the information required by this subsection to be used as the periodic report required by this subsection.[134]

This paragraph also permits the Commission, by rule, to allow

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[134] For example, members of the New York Stock Exchange must provide account statements at least quarterly under the Exchange's Rule 409(a), paragraph 2409 New York Stock Exchange Guide (CCH).

an investment adviser to provide the statement required by paragraph (1) no more frequently than annually if the client knowingly waives, in writing, the right to obtain such statement more frequently than annually. As with client waivers of the right to obtain pre-transaction disclosures, client waivers must be predicated upon an understanding of what kinds of disclosures would not be made. In this case, it is important that the client be aware, through prominent disclosures, that he will receive no more frequently than annually information pertaining to dollar amounts received directly or indirectly by the registered person, or any person associated or under common control with the registered person, pursuant to any compensation arrangement with an issuer or other third party with respect to transactions.[135] The periodic reports will provide more detailed information about fees and charges disclosed at the time of the transactions, quantify third party payments (only the existence of which is required to be disclosed at the time of the transaction), list fees and charges not imposed in connection with a transaction, and aggregate all of the charges. In addition, the Commission is authorized to require other information to be disclosed. For example, the Commission may require advisers having discretionary authority over client assets to list all of the client's security positions. The Committee understands that many advisers already provide periodic account statements to clients to which the required information could be

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[135] This provision is not intended to limit the Commission in exercising its exemptive authority under Section 206A to exempt certain advisers or certain advisers with respect to certain clients from the requirements of this section.

added.

Paragraph (3) of this subsection provides for an exception for any account for which the person is not acting as an investment adviser. As with transaction reports, when a dual registrant is not serving in its capacity as an investment adviser with regard to a client's account, periodic reports need not be made.

Subsection (e). Facilities for Filing Records and Reports. New Section 204(e) authorizes the Commission to require investment advisers to file with the Commission any fee, application, report, or notice required by the Advisers Act or by the rules thereunder through any person designated by the Commission for that purpose and to pay the reasonable costs associated with that filing. This would permit the Commission, in cooperation with the states, to develop and implement a "one-stop" system for filings required by the Advisers Act and state adviser laws through a person designated by the Commission for that purpose. This type of system would allow advisers to make one filing that would be transmitted to the Commission and the states, thus reducing paperwork for advisers and regulators.

Section 5(b). Rulemaking Required. The Commission must issue rules relating to brochure disclosure, transaction reports, and periodic reports within one year from the date of enactment of this Act.

Section 7. BOND REQUIREMENT

This section amends Section 208 of the Advisers Act, which prohibits certain activities of investment advisers, by adding a new subsection (e) directing the Commission to require certain investment advisers to obtain a fidelity bond. The fidelity bond would provide a source of funds to make whole clients who have been defrauded through larceny or embezzlement. The authority given to the Commission would extend to advisers with custody of client funds or securities, that have discretionary authority to direct client investments, or that advise investment companies. This section is modeled after Section 17(g) of the Investment Company Act of 1940, which gives the Commission authority to require a fidelity bond for investment company employees.

In implementing this section, the Commission must consider the following: the degree of risk to client assets that is involved; the cost and availability of fidelity bonds; existing fidelity bonding requirements; and any alternative means to protect client assets. The Commission may exempt certain advisers from the bonding requirement or deem the bonding requirement to be satisfied by adequate coverage by another fidelity bond. This might cover advisers who are also registered as broker-dealers and subject to bonding requirements of NASD rules.[136] The Committee expects that the Commission will avoid requiring duplicative bonding

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136 See NASD Rules of Fair Practice, paragraph 2182, Art. III, Section 32, Appendix C.

requirements.

Section 8. DISQUALIFYING CONDUCT

Section 203(e) of the Advisers Act sets out conduct for which the Commission can suspend or revoke the registration of an investment adviser. Section 203(c) requires that the Commission deny registration to applicants that would be subject to such revocation or suspension. Section 9 of this legislation adds to the list of disqualifying conduct in Section 203(e) a new paragraph (3) relating to a person that has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any crime that is punishable by imprisonment for one or more years or of a substantially equivalent crime by a foreign court of competent jurisdiction.

Section 9. CONFIDENTIALITY

This section amends Section 208 of the Advisers Act by adding a new subsection (f), making it unlawful for any investment adviser to disclose any personally identifiable financial information with respect to any client, unless the adviser is required to do so by law or unless: (A) the client has been adequately informed of the proposed information disclosure, in accordance with rules prescribed by the commission, and (i) has been afforded the opportunity, in accordance with such rules, to object to the disclosure, and (ii) has not objected or has affirmatively

consented; (B) the information disclosed is necessary and appropriate in order to establish an advisory or brokerage account or to effect a transaction for the client; (C) the information is requested by representatives of the Commission, a state agency whose primary assignment is the regulation of the securities business, or a self-regulatory organization; or (D) the information is requested by the client's auditors or accountants. Of course, an adviser could provide the information to its legal counsel in the context of soliciting or obtaining legal advice, where the attorney is obligated to maintain the confidentiality of the communication.

This section also makes it unlawful for any person to whom information is disclosed in order to effect or attempt to effect a transaction for the account of a client to use such information for any purpose other than the effectuation of the client's transaction.

For purposes of this section, the term "personally identifiable financial information" is intended to encompass information that, directly or indirectly, links a person's identity to information about that person's finances or economic or financial status. For example, a list of names indicating that all persons on the list earn in excess of a certain amount would qualify as personally identifiable financial information. Using financial information from a client to create a model portfolio, without any way to identify the client, would not constitute such personally

identifiable financial information.

The scope of consent by the client pursuant to subparagraph (A) is delimited by -- and coextensive with -- the terms of the proposed information disclosure by the adviser. The client can, of course, provide partial consent by agreeing to certain disclosures but not to others. The adviser is bound by the scope and nature of that client's consent. In order for consent to be effective, the client must be fully and fairly informed, in a manner that the client is likely to comprehend and in readable form, of the nature and extent of the proposed disclosure of information. Where consent is to be inferred from the client's failure to object to a disclosure, the Committee intends that a reasonable time be afforded the client in which to object.

With respect to the disclosure of information to the Commission, the Committee intends for the Commission to have full access to information relating to clients as that information relates to the Commission's enforcement and regulatory responsibilities under the federal securities laws. In particular, this provision is not intended to affect in any manner the Commission's ability to obtain information from any person in connection with its large trader reporting program under Section 13(h) of the Exchange Act.[137]

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137 15 U.S.C. Section 78m(h).

Section 10. FEDERAL-STATE COOPERATION

This section amends Section 209 of the Advisers Act by adding a new subsection (f) that establishes the policy objective of greater federal and state cooperation and coordination in the regulation of investment advisers in order to achieve the greatest effectiveness of regulation, examination, and enforcement, and the greatest uniformity in federal and state regulatory standards. To these ends, the Commission is required to conduct studies and hold meetings as necessary, and to submit to Congress, no later than two years after the date of enactment of this Act, any legislative recommendations necessary to carry out the policy and purposes set forth in this Act.

This section is intended to encourage, to the extent possible, uniformity among the states in their laws relating to investment advisers as well as between state and federal law. To date, cooperation both among the states and between the states and the Commission has been exemplary. This provision merely encourages it to continue.

AGENCY VIEWS

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

September 16, 1992

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your request for the Commission's views on H.R. 5726, the "Investment Adviser Regulatory Enhancement and Disclosure Act of 1992," as it was reported out of the Committee on Energy and Commerce on August 4, 1992.1/

H.R. 5726 is an important bill that would provide the Commission with critically needed resources to support an enhanced inspection program by imposing modest annual fees on registered investment advisers. These resources should permit the Commission to improve substantially its examination of investment advisers and enable it better to protect the millions of American investors, pensioners, municipalities, educational institutions and others who, directly or indirectly, employ the services of investment advisers. In particular, the Commission strongly supports the provisions of H.R. 5726 that deal with adviser fees, fidelity bonding and suitability.

In addition, we have the following specific comments regarding H.R. 5726:

Section 2. Additional Resources. Section 2 would authorize the Commission to collect fees upon application for registration under the Advisers Act and annually thereafter. The fees are set forth in a schedule contained in Section 2 and are scaled based on assets under management. They range from $300 (which approximately 80% of advisers will pay) to $7,000 (which only the largest money managers will pay). The fees would be retained by the Commission and used to cover the costs of registration, supervision and regulation of investment advisers. The fees are apportioned fairly so as not to have a material adverse financial or competitive effect on investment advisers. The Commission strongly supports this provision.

1/ Commissioner Roberts does not concur with the views expressed in this letter.

Section 3. Inspections and Surveys.

a. Inspections. Section 3 would require the Commission to establish, and revise periodically, a schedule for the inspection of advisers. The legislation mandates that the schedule require more frequent inspection of advisers based on the factors that the Commission determines increase the need for inspecting those advisers. The Commission now focuses its inspection resources on high-risk advisers and, obviously, does not object to a risk-based approach.

However, Section 3 additionally requires more frequent inspection of certain advisers within one year of their registration with the Commission, as well as more frequent follow-up inspections. These requirements could cause the Commission to distort its inspection schedule away from one based on an evaluation of risk factors. They also impair the Commission's ability to respond flexibly to developments in the marketplace. For these reasons, we oppose these additional requirements.

b. Surveys. Section 3 also would direct the Commission to conduct surveys to identify advisers who fail to register and report to Congress on its findings and recommendations. The legislation incorrectly assumes that without such a requirement the Commission will fail to enforce the registration provisions of the Advisers Act. The Commission intends to enforce vigorously these provisions. We believe that the monies spent conducting formal surveys could be better used in conducting inspections and prosecuting violations.

Section 4. Designation of Self-Regulatory Organizations. The Commission would be authorized to designate one or more self-regulatory organizations (SROs) registered with the Commission to conduct periodic examinations of certain of its investment adviser members and affiliates. The Commission is not opposed to this provision since there may be some efficiencies achieved by the involvement of an SRO, particularly where the advisory firm is part of a broker-dealer that is already examined by the SRO.

Section 5. Suitability and Other Adviser Obligations. Section 5 would amend the Adviser Act's anti-fraud provisions in three principal respects:

(a) Suitability. Section 5 would make explicit the requirement implicit in the general anti-fraud provisions of the Advisers Act that advisers make a reasonable determination that the advice they give is suitable to their clients. The Commission believes that both investors and the advisory industry would benefit if Congress made explicit this very important

obligation and strongly supports this provision. The section would require an adviser, before giving advice and as appropriate thereafter, to make a reasonable inquiry into the client's financial situation, and that advisers keep records of the information obtained from the inquiry.

(b) Associated Persons. Section 5 would extend the anti-fraud provisions of the Advisers Act to persons associated with the investment advisers. These persons include the principals and employees who are actually formulating or delivering the investment advice. Currently, these persons can only be charged as aiders and abettors of the adviser. This provision is a needed correction to what appears to be a drafting error in the Advisers Act.

(c) Prohibition on Investment Guarantees. Section 5 would add a provision prohibiting advisers from guaranteeing specific investment results. This provision, which the Commission supports, would make explicit a prohibition already implicit in the Advisers Act.

Section 6. Additional Disclosure Obligations of Investment Advisers. Section 6 would amend the Advisers Act disclosure requirements in four respects:

(a) Brochure. Section 6 would require an adviser to deliver to clients a brochure describing the adviser's fees, education, business background and business practices, including prominent disclosures about commissions the adviser may receive. The Commission supports this provision which, in many respects, codifies the Commission's existing "brochure rule." However, because the provision in many ways tracks existing law, the Commission does not believe this provision is a critical part of this legislation and would not object if the provision were omitted.

(b) Transaction Reports. Section 6 would require advisers to disclose to clients, before affecting a transaction, the commissions and other fees that the adviser reasonably expects the client will pay, the fact that the adviser or an affiliate will receive a portion of the commission, and the existence of any third-party compensation arrangements. This disclosure may be made orally unless the advice is in writing. Pre-transaction disclosure must be followed by a written confirmation setting forth the amounts actually charged or deducted. The section would except accounts over which the adviser has discretionary authority. It would also not apply to transactions in which neither the adviser nor any person associated with or under common control with the adviser will receive any portion of the fees or commissions imposed.

The purpose of this new requirement is to provide clients with information to evaluate the existence and magnitude of the conflict of interest advisers have with clients when they sell clients investment products they have recommended. While the goal is laudable, it could be achieved in a less burdensome manner by requiring (i) brochure disclosure that the adviser engages in these practices and the nature of the conflicts engendered, and (ii) periodic reports to clients disclosing the commissions, fees and charges the client has paid. If the client is advised of these practices before engaging the adviser, the client can choose to seek the services of a different adviser or can inquire as to the amount of commissions when each transaction is recommended. If, upon receipt of a periodic report, the client believes that the charges are too high, he or she can terminate the advisory relationship.

(c) Periodic Reports. Advisers would be required to provide clients with periodic written statements of sales commissions paid to the adviser or persons associated with or under common control with the adviser. The Commission would be given authority to specify the timing and format of the reports. The Commission believes that this provision would be less burdensome than the transaction reporting provision since advisers should be able to include this information in periodic account statements which most advisers already send clients.

(d) One-Stop Filing. The Commission would be authorized to designate one entity with whom advisers would be required to file any fee, application, report, or notice required to be filed with the Commission. The Commission could permit the operator of the system to charge a fee for the reasonable costs of running the system. Such a system would permit an adviser to make one filing with the system operator and have it electronically communicated to all state regulators and the Commission. A similar one-stop filing system is currently in place for broker-dealers. The Commission supports this provision since it would reduce paperwork burdens for filers and regulators.

Section 7. Fidelity Bond Requirement. The Commission would be required to adopt a rule requiring advisers with investment discretion over or custody of client assets, or who advise investment companies, to obtain fidelity bonds against theft or embezzlement. The Commission has found that when serious frauds involving theft or embezzlement are discovered, the perpetrators often have inadequate assets to compensate clients. Fidelity bonds would provide a source of funds from which harmed clients could be made whole. The Commission strongly supports this provision.

<u>Section 8. Disqualifying Conduct</u>. The Commission would be authorized to deny registration to persons convicted of any felony in the past ten years. The Advisers Act's disqualification provisions are currently based solely on specific crimes primarily relating to financial matters or theft. In a few cases the Commission has had some difficultly in keeping an obviously unfit felon from registering. The Commission supports this provision.

<u>Section 9. Confidentiality</u>. Advisers would be prohibited from disclosing personally identifiable financial information with respect to any client unless required to do so by law or unless the client has been adequately informed of the proposed disclosure and has not objected or has consented. Exceptions would be made for information necessary to establish brokerage accounts and effect securities transactions, and information requested by the Commission, a state securities authority, or a self-regulatory organization. The Commission is concerned that this provision not be read to limit in any way the Commission's collection and use of information for its regulatory and enforcement purposes.

<u>Section 10. Federal-State Cooperation</u>. The Commission would be authorized to cooperate and coordinate with state securities administrators or their associations for the purpose of developing greater uniformity in the regulation of investment advisers among the states and between the states and the Commission. The Commission would be required to submit to Congress within two years any legislative recommendations the Commission believes are necessary to carry out the purpose of Section 10.

The Commission currently expends a great deal of effort cooperating and coordinating with the states on Advisers Act matters as instructed by Section 19(c) of the Securities Act of 1933. The current lack of uniformity does not stem from the Commission's failure to coordinate but rather from the difficulty the states have of maintaining uniformity among themselves once the Commission and the states have coordinated. The Commission does not support Section 10 because we do not believe that Section 10 will address the problem of lack of uniformity and would add additional unproductive costs to the Commission's budget.

* * * *

In summary, H.R. 5726 would provide important new protections for investors by giving the Commission resources to enhance the investment adviser inspection program and authorize the Commission to require that certain advisers obtain fidelity

bonds. It would also make explicit the suitability requirement currently implicit in the Adviser Act's anti-fraud provisions. Other provisions, such as those requiring improved brochure disclosure and periodic reports to clients, authorizing the Commission to deny registration to all felons, and expanding the anti-fraud provisions to cover associated persons also provide useful investor protections. However, the Commission does not support those provisions discussed above that limit the Commission's flexibility in administering the Advisers Act or that are unduly burdensome to investment advisers.

Thank you for the opportunity to provide the Commission's views on H.R. 5726.

Sincerely,

Richard C. Breeden
Chairman

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman):

INVESTMENT ADVISERS ACT OF 1940

TITLE II—INVESTMENT ADVISERS

* * * * * * *

REGISTRATION OF INVESTMENT ADVISERS

SEC. 203. (a) * * *

* * * * * * *

(e) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associated—

(1) * * *

* * * * * * *

(3) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any crime that is punishable by imprisonment for one or more years and that is not described in paragraph (2) of this subsection or of a substantially equivalent crime by a foreign court of competent jurisdiction.

[(3)] *(4)* is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction, including any foreign court of competent jurisdiction, from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation, or as an affiliated person or employee of any investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

[(4)] *(5)* has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Invest-

ment Company Act of 1940, this title, the Commodity Exchange Act, or the rules or regulations under any such statutes or any rule of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

[(5)] *(6)* has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, this title, the Commodity Exchange Act, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this paragraph [(5)] *(6)* no person shall be deemed to have failed reasonably to supervise any person, if—

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

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

[(6)] *(7)* is subject to an order of the Commission entered pursuant to subsection (f) of this section barring or suspending the right of such person to be associated with an investment adviser which order is in effect with respect to such person.

[(7)] *(8)* has been found by a foreign financial regulatory authority to have—

(A) made or caused to be made in any application for registration or report required to be filed with a foreign securities authority, or in any proceeding before a foreign securities authority with respect to registration, any statement that was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to a foreign securities authority any material fact that is required to be stated therein;

* * * * * * *

(f) The Commission, by order shall censure or place limitations on the activities of any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated, with an investment adviser, or suspend for a period not exceeding twelve months or bar any such person from being associated with an investment adviser, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in [paragraph (1), (4), (5), or (7)] *paragraph (1), (5), (6), or (8)* of subsection (e) of this section or has been convicted of any offense specified in paragraph (2) of said subsection (e) within ten years of the commencement of the proceed-

ings under this subsection, or is enjoined from any action, conduct, or practice specified in paragraph [(3)] *(4)* of said subsection (e). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with an investment adviser is in effect willfully to become, or to be, associated with an investment adviser without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care, should have known, of such order.

* * * * * * *

(i) MONEY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.—

(1) AUTHORITY OF COMMISSION.—In any proceeding instituted pursuant to subsection (e) or (f) against any person, the Commission may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person—

(A) * * *

* * * * * * *

(D) has failed reasonably to supervise, within the meaning of [section 203(e)(5) of this title] *subsection (e)(6) of this section*, with a view to preventing violations of the provisions of this title and the rules and regulations thereunder, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest.

FEES FOR REGISTRANTS AND APPLICANTS

SEC. 203A. (a) IN GENERAL.—The Commission is authorized, in accordance with this section, to collect fees to recover the costs of registration, supervision, and regulation of investment advisers and their activities. Such fees shall be collected, and shall be available, only to the extent provided in advance in appropriations Acts. No appropriation Act may authorize fees to be collected under this section during any fiscal year unless the amount appropriated by such Act for such costs for such fiscal year equals or exceeds the aggregate amount that may reasonably be expected to be collected by such fees. Such fees shall be deposited as an offsetting collection to the Commission's appropriation and may remain available for such purposes for the succeeding fiscal year. The costs covered by such fees shall be limited to the costs of Commission expenses for registration, examinations, and surveys of persons registered or required to register under this Act.

(b) TIME FOR PAYMENT.—

(1) NEW REGISTRANTS.—At the time of filing an application for registration under this title, the applicant shall pay to the Commission the fee specified in subsection (c). No part of such fee shall be refunded to the applicant. The filing of an application for registration under this title shall not be deemed to have occurred unless the application is accompanied by the fee required under this section.

(2) ONGOING REGISTRANTS.—Each investment adviser whose registration is effective on the last day of its fiscal year shall pay to the Commission the fee specified in subsection (c). Such

payment shall be made not later than 90 days after the end of its fiscal year, or at such other time as the Commission, by rule, shall determine, unless its registration has been withdrawn, canceled, or revoked prior to that date. No part of such fee shall be refunded to the investment adviser.

(c) COST-BASED SCHEDULE OF FEES.—For any fiscal year for which fees are authorized to be collected by an appropriation Act, the amount of fees due from investment advisers in accordance with paragraphs (1) and (2) of subsection (b) shall be determined according to the following schedule:

Assets under management	*Fee due:*
Less than $10,000,000	*$ 300*
$10,000,000 or more, but less than $25,000,000	*$500*
$25,000,000 or more, but less than $50,000,000	*$1,000*
$50,000,000 or more, but less than $100,000,000	*$2,500*
$100,000,000 or more, but less than $250,000,000	*$4,000*
$250,000,000 or more, but less than $500,000,000	*$5,000*
$500,000,000 or more	*$7,000.*

(d) ADJUSTMENT OF FEES.—The Commission may, by rule, adjust the fees specified in subsection (c) by a percentage not greater than the percentage change in the Consumer Price Index for All Urban Consumers; U.S. City Average, All Items Index (or a similar successor index of the Bureau of Labor Statistics of the Department of Labor)—

(1) between the February 1992 version of such index and the most recent version of such index that is in effect; or

(2) if one or more adjustments have been made under this section after the date of enactment of this section, between the version of such index in effect at the time of the most recent adjustment and the most recent version of such index that is in effect.

(e) SUSPENSION FOR FAILURE TO PAY.—The Commission, by order, may suspend the registration of any investment adviser if it finds, after notice, that such investment adviser has failed to pay when due any fee required by this section. The Commission shall reinstate such registration upon payment of the fee (and any penalty due), if such suspension was based solely on the failure to pay the fee.

(f) RULEMAKING.—The Commission may adopt such rules as are necessary to carry out this section.

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[ANNUAL AND OTHER REPORTS]

PERIODIC REPORTS AND OTHER DISCLOSURE REQUIREMENTS

SEC. 204. *(a) PERIODIC AND OTHER REPORTS.*—Every investment adviser who makes use of the mails or of any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser (other than one specifically exempted from registration pursuant to section 203(b) of this title), shall make and keep for prescribed periods such records (as defined in section 3(a)(37) of the Securities Exchange Act of 1934), furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. All records (as

so defined) of such investment advisers are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

(b) BROCHURE REQUIRED.—

(1) IN GENERAL.—Each person registered under section 203 of this title shall disseminate to each client or prospective client a document disclosing material facts concerning matters listed in paragraphs (2) and (3) and such other matters as the Commission shall prescribe. In order to provide for timely and effective disclosure of such facts and matters to clients, the Commission shall by rule prescribe the format of the document and the timing of its dissemination.

(2) CONTENTS OF BROCHURE.—The document required by paragraph (1) shall include information concerning—

(A) the education and business background of such person and of any associated person providing significant investment advisory services to the client,

(B) compensation arrangements between the client and the investment adviser,

(C) the nature of services offered,

(D) business practices,

(E) methods for obtaining information on the disciplinary history and registration of the investment adviser and persons associated with the investment adviser, and

(F) conflicts of interest which could reasonably be expected to impair the rendering of disinterested advice.

(3) PROMINENT DISCLOSURES.—Such document shall also prominently disclose—

(A) that—

(i) the registered person receives or may receive, directly or indirectly, sales commissions or other fees in connection with a purchase or sale effected on behalf of a client; or

(ii) the registered person will not receive, directly or indirectly, any sales commission or other fees in connection with such purchase or sale, but the client may be charged a sales commission or other fee by another person in connection with such purchase or sale; and

(B) that remedies may be available to the client with respect to disputes arising out of the advisory relationship.

(4) DEFINITION.—The Commission shall define "associated person providing significant investment advisory services to the client" by rule for purposes of this subsection.

(c) TRANSACTION REPORTS.—

(1) INITIAL DISCLOSURE.—Each person registered under section 203 shall disclose to each client, before a purchase or sale is effected on behalf of the client—

(A) the total amount of sales commissions or other fees that may reasonably be expected to be charged or deducted in connection with the purchase or sale;

(B) that the adviser will receive such amount or a portion of such amount, or, in the case of a transaction to be ef-

fected through a broker or a dealer that is a person associated or under common control with the adviser, that the broker or dealer is affiliated with the adviser and will receive such amount or portion of such amount; and

(C) the existence of any compensation arrangement with an issuer or other third party with respect to the recommended transaction.

Such initial disclosure shall be in writing if the purchase or sale was recommended in writing. The Commission may, by rule, permit an investment adviser to omit disclosure required by this paragraph with the knowing written consent of the client.

(2) CONFIRMATION.—After such purchase or sale is effected, the investment adviser shall transmit to each client a written statement that discloses—

(A) the amount of sales commission or other fees that have been charged or deducted in connection with the purchase or sale; and

(B) the information required to be disclosed by paragraph (1)(C).

(3) COMMISSION RULES.—The written statement required under paragraph (2) shall be in such form and contain such information, and be provided in accordance with such rules, as the Commission shall prescribe. Such rules shall, to the extent consistent with the protection of investors, permit a confirmation statement of a broker or dealer that contains the information required by this subsection to be used as the written statement required by this subsection.

(4) EXCEPTIONS.—This subsection shall not apply—

(A) with respect to any purchase or sale for which the registered person, and any person associated or under common control with the registered person, will not receive any portion of the amount charged or deducted in connection with the purchase or sale, and will not receive any payment under a compensation arrangement required to be disclosed under paragraph (1)(C);

(B) with respect to accounts for which the person is authorized to exercise investment discretion; or

(C) with respect to any account for which the person is not acting as an investment adviser.

(5) SPECIAL RULE.—The provisions of this subsection shall also apply to persons associated with an investment adviser effecting transactions for advisory clients through a broker or dealer with which the person is associated.

(d) PERIODIC REPORTS.—

(1) IN GENERAL.—Each person registered under section 203 of this title shall periodically provide to each client a written statement of—

(A) the sales commissions and other fees paid by the client for all services provided by the registered person and any person associated or under common control with the registered person;

(B) any amounts received directly or indirectly by the registered person, or any person associated or under common

control with the registered person, pursuant to any compensation arrangement with an issuer or other third party with respect to the recommended transaction; and

(C) such other matters as the Commission shall prescribe.

(2) COMMISSION RULES.— The Commission shall prescribe by rule the format of the statement and timing of its delivery. Such rule shall require that the format and timing of delivery be designed to present the required information in a manner that readily permits clients to compare the costs charged by the investment adviser with the costs charged by other advisers for comparable services. In adopting such rules, the Commission shall require an investment adviser whose clients purchase or sell investment products through persons other than such adviser, or persons associated or under common control with such adviser, to indicate to its clients that such information concerning costs charged does not include commissions or other fees paid in connection with such purchases or sales. The Commission's rules under this subsection shall permit a periodic report of a broker or dealer that contains the information required by this subsection to be used as the periodic report required by this subsection. The Commission may, by rule, permit an investment adviser to provide the statement required by paragraph (1) no more frequently than annually if the client knowingly waives, in writing, the right to obtain such statement more frequently than annually.

(3) EXCEPTION.—This subsection shall not apply with respect to any account for which the person is not acting as an investment adviser.

(e) FACILITIES FOR FILING RECORDS AND REPORTS.—The Commission, by rule, may require any investment adviser—

(1) to file with the Commission any fee, application, report, or notice required by this title or by the rules issued under this title through any person designated by the Commission for that purpose; and

(2) to pay the reasonable costs associated with such filing.

* * * * * * *

[PROHIBITED TRANSACTIONS BY REGISTERED INVESTMENT ADVISERS

[Sec. 206. It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

[(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 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 trans-

action. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

[(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.]

PROHIBITED TRANSACTIONS BY INVESTMENT ADVISERS

SEC. 206. (a) PROHIBITED CONDUCT.—It shall be unlawful for any investment adviser or any person associated with an investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(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 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;

(5) to provide investment advice to any client, other than in connection with impersonal advisory services, unless the adviser—

(A) prior to providing any investment advice, and as appropriate thereafter, makes a reasonable inquiry into the client's financial situation, investment experience, and investment objectives;

(B) reasonably determines that the investment advice is suitable for the client; and

(C) maintains reasonable records, in accordance with such rules as the Commission shall prescribe, of the information obtained from the inquiries the adviser made in complying with this paragraph; or

(6) to guarantee a client that a specific result will be achieved as a result of the investment advisory services.

(b) EXEMPTIONS AND SPECIAL RULES.—

(1) EXEMPTION.—The prohibitions of subsection (a)(3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.

(2) AUTHORITY TO DEFINE AND PRESCRIBE.—The Commission shall, for the purposes of subsection (a)(4), by rules define, and prescribe means reasonably designed to prevent, such acts,

practices, and courses of business as are fraudulent, deceptive, or manipulative.

(3) DEFINITION OF IMPERSONAL ADVISORY SERVICES.—As used in subsection (a)(5), the term "impersonal advisory services" means any investment advisory services provided—

(A) by means of written material or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts;

(B) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or

(C) by any combination of the foregoing services.

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GENERAL PROHIBITIONS

SEC. 208. (a) * * *

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(e) BOND REQUIREMENT.—

(1) IN GENERAL.—The Commission shall require, by rules for the protection of investors, that any investment adviser registered under section 203 who—

(A) is authorized to exercise investment discretion, as defined in section 3(a)(35) of the Securities Exchange Act of 1934, with respect to an account,

(B) has access to the securities or funds of a client, or

(C) is an investment adviser of an investment company, as defined in section 2(a)(20) of the Investment Company Act of 1940,

shall obtain a bond from a reputable fidelity insurance company against larceny and embezzlement in such reasonable amounts and covering such officers, partners, directors, and employees of the investment adviser as the Commission may prescribe.

(2) CONSIDERATIONS IN RULEMAKING.—In implementing paragraph (1), the Commission shall consider—

(A) the degree of risk to client assets that is involved;

(B) the cost and availability of fidelity bonds;

(C) existing fidelity bonding requirements; and

(D) any alternative means to protect client assets.

(f) DISCLOSURE OF CLIENT INFORMATION PROHIBITED.—

(1) ADVISER DISCLOSURE.—It shall be unlawful for any investment adviser to disclose any personally identifiable financial information with respect to any client unless required by law to do so, or unless—

(A) the client has been adequately informed of the proposed information disclosure, in accordance with rules prescribed by the Commission, and (i) has been afforded the opportunity, in accordance with such rules, to object to the disclosure, and (ii) has not objected or has affirmatively consented;

(B) the information disclosed is necessary and appropriate in order to establish an advisory or brokerage ac-

count or to effect or attempt to effect a transaction for the client;

(C) the information is requested by representatives of the Commission, a State agency whose primary assignment is the regulation of the securities business, or a self-regulatory organization in connection with their respective regulatory or enforcement responsibilities as to the investment adviser or the information is requested by a Commission subpoena; or

(D) the information is requested by the client's auditors or accountants.

(2) SECONDARY DISCLOSURE.—It is unlawful for any person to whom information is disclosed for the purpose described in paragraph (1)(B) to use such information for any purpose other than the effectuation of the client's transaction.

ENFORCEMENT OF TITLE

SEC. 209. (a) * * *

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(f) FEDERAL-STATE COOPERATION.—

(1) AUTHORITY.—The Commission is authorized to cooperate with State agencies whose primary assignment is the regulation of the securities business or any association of State securities officials they designate, and which, in the judgment of the Commission, could assist in obtaining greater effectiveness in Federal and State regulation of investment advisers. The Commission shall cooperate, coordinate, and may (in its discretion) share information with such agencies or associations for the purposes of carrying out the policies and purposes set forth in paragraphs (2) and (3).

(2) POLICY.—It is the declared policy of this subsection that there should be greater Federal and State cooperation and coordination in the regulation of investment advisers in order to achieve—

(A) maximum effectiveness of regulation, examination, and enforcement, and

(B) maximum uniformity in Federal and State regulatory standards.

(3) PURPOSE.—The purpose of this subsection is to engender cooperation between the Commission, any such agencies or associations, and other duly constituted securities associations in the following areas:

(A) the sharing of information regarding the registration or exemption of investment advisers and the conduct of their business in the various States;

(B) the development and maintenance of uniform examination standards and procedures; and

(C) the development of a uniform exemption from registration for small investment advisers which can be agreed upon among several States or between the States and the Federal Government where consistent with the public interest and the protection of investors and the purposes of this Act.

Nothing in this subsection shall be construed as authorizing the preemption of State law.

(4) STUDIES AND RECOMMENDATIONS.—In order to carry out these policies and purposes, the Commission shall conduct such studies and meetings as the Commission considers necessary. The Commission shall submit to Congress, not later than 2 years after the date of enactment of this subsection, any legislative recommendations necessary to carry out the policy and purpose of this subsection.

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EXAMINATIONS AND SURVEYS

SEC. 223. (a) PERIODIC EXAMINATIONS.—The Commission shall establish and periodically revise a schedule for the regular examination of investment advisers. Such schedule shall provide for more frequent examinations of certain investment advisers based on factors that the Commission determines increase the need for examination of those investment advisers, including the frequency of customer complaints, custody of funds, authority to exercise investment discretion, and receipt of commissions for the sale of investments recommended to clients. In addition, such schedule shall require more frequent examinations in order to—

(1) assure that new investment advisers have adequate compliance procedures through examinations of investment advisers within approximately one year of their registration under section 203(a), taking into account the level of risk presented by advisers' activities; and

(2) conduct follow-up examinations of investment advisers found to have deficiencies that may continue to present high risks to their clients.

(b) SURVEYS OF UNREGISTERED PERSONS.—The Commission shall, within 3 years after the date of enactment of this section and periodically thereafter, provide for the conduct of a survey to determine the extent of, and reasons for, the failure of persons to register as required by this Act. The Commission shall, on the basis of such survey results, establish objectives for the reduction or elimination of such failures and shall include in annual reports to Congress (under section 23(b) of the Securities Exchange Act of 1934) submitted after completion of the first survey, a statement of such objectives, an evaluation of the success in attaining those objectives during the preceding year, and such recommendations as the Commission considers appropriate to assist in the attainment of those objectives. If the survey identifies any pattern of misinterpretation of the definition of investment adviser as the basis for such failures, the Commission's objectives shall include such rulemaking proceedings as may be required to correct such misinterpretation.

(c) PROVISIONS NOT LIMITATION.—The provisions of this section shall not be construed to limit the authority of the Commission to conduct an examination or investigation at any time or to institute proceedings under section 203 or 209 of this Act or any other title.

DESIGNATION OF SELF-REGULATORY ORGANIZATIONS

SEC. 224. (a) DESIGNATION TO CONDUCT EXAMINATIONS.—The Commission, by rule, consistent with the public interest, the protection of investors, and the purposes of this title, may designate one or more self-regulatory organizations registered with the Commission under sections 6 or 15A of the Securities Exchange Act of 1934, to conduct periodic examinations of its members and affiliates of members to determine compliance with applicable provisions of this title and the rules and regulations thereunder. Such rules shall specify the minimum scope and frequency for such examinations and shall be designed to avoid unnecessary regulatory duplication or undue regulatory burdens. Such self-regulatory organization may discipline its members and affiliates of members for violations of the applicable provisions of this title and the rules and regulations thereunder pursuant to the standards and procedures set forth in sections 6 and 15A of the Securities Exchange Act of 1934. The penalties imposed by a self-regulatory organization for violations of this title shall not exceed those contained in section 217.

(b) LIMITATION.—The Commission shall not exercise the designation authority contained in subsection (a) for members or affiliates of members if the primary business of the member and its affiliates is investment advisory activities. The Commission, by rule, may establish criteria for defining the term "primary business".

(c) AUTHORITY TO IMPOSE FEES.—

(1) IN GENERAL.—Any self-regulatory organization designated by the Commission to perform the examinations specified in subsection (a) shall have the authority to collect fees in accordance with this subsection.

(2) LIMITATION.—The total fee paid by a registered investment adviser under this subsection shall not exceed an amount determined in accordance with rules prescribed by the Commission. Such rules shall require that the fees collected by a self-regulatory organization under this subsection—

(A) cover only the costs of the self-regulatory organization's expenses for examinations conducted pursuant to subsection (a);

(B) as to any investment adviser, bear a reasonable relationship to the costs of conducting an examination of that adviser pursuant to subsection (a); and

(C) not exceed such portion of the fee authorized under section 203A as the Commission determines is allocable to the Commission's expenses for conducting such an examination.

(3) REDUCTION OF SECTION 203A FEES.—The amount of any fee that a registered investment adviser is required to pay under section 203A with respect to any fiscal year shall be reduced by the amount paid to a self-regulatory organization in accordance with this subsection with respect to such fiscal year.

(d) EFFECTIVE DATE OF RULE.—A rule prescribed by the Commission under this section shall not be effective until 90 days after the date on which the Commission submits to each House of Congress a report—

(1) containing the text of the proposed rule and the reasons therefor;

(2) describing the procedures to be used to coordinate the collection of fees by the Commission under section 203A and by a self-regulatory organization under the rule; and

(3) containing such other information as may be necessary to describe the implementation and enforcement of the rule.

(e) DEFINITION.—For purposes of this section, the term "affiliate" shall mean any person directly or indirectly controlling, controlled by, or under common control with a member.