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

THE CHAIRMAN

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.

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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 effecting 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 fliers 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.

Section 8. Disqualifying Conduct. 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 difficulty in keeping an obviously unfit felon from registering. The Commission supports this provision.

Section 9. Confidentiality. 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.

Section 10. Federal-State Cooperation. 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.

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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