

December 18, 2007

Via Electronic Filing

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

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

Dear Secretary Paulson:

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

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

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

¹ The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the IAA's membership today is comprised of more than 500 firms that collectively manage in excess of \$9 trillion for a wide variety of institutional and individual clients. For more information, please see www.investmentadviser.org.

² Public Law No. 76-768, 54 Stat. 847.

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

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

Investment Adviser Regulation and Fiduciary Duty

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

Efficacy of SEC as Primary Regulator

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

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

³ *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) (*Capital Gains*). Our current standards of practice are available at our website at www.investmentadviser.org

⁴ National Securities Markets Improvement Act, Public Law No. 104-290.

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

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

Diversity of Investment Adviser Profession

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

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

⁵ See, e.g., IAA/NRS, *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* at 5-6 (Aug. 2007), available on our website.

⁶ *Id.* More than 83% of SEC-registered advisory firms manage less than \$1 billion in assets.

⁷ *Id.*

⁸ *Id.* 8-9. Only 628 investment advisers (6 percent) are dually registered as broker-dealers. In addition, 436 advisers (4.2%) are registered as a futures commission merchant, commodity pool operator or commodity trading adviser; 87 advisers (0.8%) are real estate brokers, dealers or agents; 1,266 advisers (12.1%) are also insurance brokers or agents; 52 advisers (0.5%) are either a bank or a separately identifiable department or division of a bank; and 2,569 advisers (24.5%) sell products or provide services other than investment advice to advisory clients.

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

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

Costs of Regulation

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

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

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

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

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

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

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

Regulatory Reform Process Must be Open and Inclusive

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

* * * * *

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Broker-Dealer Exception

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

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

¹⁵ Section 202(a)(11), Advisers Act.

¹⁶ Section 202(a)(11)(B), Advisers Act.

¹⁷ *Proposal* supra note 13. As noted in the proposed rule, broker-dealers had created services that involved the receipt of asset-based fees. Up until the proposed rule was released, receipt of such “special compensation” had meant that a broker-dealer could not claim the exception in the Advisers Act. The proposed rule would have allowed brokers to offer fee-based accounts to clients on a nondiscretionary basis as long as any investment advice provided was solely incidental to their brokerage services.

¹⁸ Letter from David G. Tittsworth, Executive Director, ICAA, to Jonathan G. Katz, Secretary, SEC (Jan. 12, 2000) (hereinafter “Jan. 12, 2000 Letter”). While we agreed with the SEC that a functional test that focuses on the nature of services provided – rather than the form of the broker-dealer’s compensation – is appropriate in determining whether a brokerage account falls within the Advisers Act, we expressed our view that the SEC’s functional analysis did not go far enough.

¹⁹ *Reproposal*, supra note 14, at 36.

The SEC's rulemaking relating to the broker-dealer exception under the Advisers Act was invalidated by the D.C. Circuit Court of Appeals on March 30, 2007.²⁰ In response to the court's ruling, we, along with other groups, wrote the SEC noting that "[a] long-term response to the Court decision will require complex decisions about a variety of issues, including how best to draw a functional distinction between brokers and investment advisers, determining the appropriate standards to apply to the range of activities engaged in by investment service providers, how to educate investors to make informed choices among the various types of providers, and what disclosures are appropriate to inform investors of the differing roles of these providers and of the applicable legal protections."²¹

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

Bank Exception

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

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

²⁰ *Financial Planning Association v. S.E.C.*, 2007 WL 935733, C.A.D.C. (Mar. 30, 2007).

²¹ See Letter from David G. Tittsworth, IAA, Consumer Federation of America, Financial Planning Association, Fund Democracy, National Association of Personal Financial Advisors, and North American Securities Administrators Association, to the Honorable Christopher Cox, Chairman (Apr. 24, 2007).

²² *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, Rel. No. IA-2562 (Sept. 24, 2007).

²³ *Id.*

²⁴ See Letter from Karen L. Barr, General Counsel, IAA, to Nancy M Morris, Secretary, SEC (Nov. 30, 2007).

²⁵ Section 202(a)(11)(A), Advisers Act. On October 13, 2006, the Financial Services Regulatory Relief Act of 2006 was enacted exempting thrifts from the Advisers Act to the same extent as banks. Public Law No. 109-351.

²⁶ Letter from Ramsay D. Potts, Counsel, ICAA, to Ronald F. Hunt, Secretary, Securities and Exchange Commission (Oct. 6, 1972) (emphasis added). See also Letter from David G. Tittsworth, Executive Director, ICAA, to Harvey L. Pitt, Chairman, SEC (Dec. 27, 2001); Letter from David G. Tittsworth, Executive Director, ICAA, to Jonathan G. Katz, Secretary, SEC (July 9, 2004).

As the Commission has urged for more than a decade, a system of functional regulation would eliminate the inconsistencies between regulation of securities activities of banks and securities activities of Commission-regulated entities, providing enhanced investor protection....

To assure adequate investor protection, the Commission believes that bank securities activities must be brought within the securities regulatory framework. Such an approach would ensure that the securities activities of all market participants – regardless of the structure in which they are conducted – would be subject to a single set of standards, consistently applied by one expert regulator.²⁷

As part of the Gramm-Leach-Bliley Act²⁸ enacted in 1999, Congress amended section 202(a)(11)(A) of the Advisers Act to provide that the term “investment adviser” includes a bank or bank holding company that “serves or acts as an investment adviser to a registered investment company. . .”²⁹ While the IAA believes this provision was a step forward in attaining appropriate functional regulation, it begs the question of why banks that act as an investment adviser in other cases should not also be subject to the protections and regulations of the Advisers Act.

Hedge fund adviser exception

Hedge funds offer a number of potential benefits to eligible investors by providing an alternative investment strategy that may reduce portfolio risk, increase investment returns during difficult market or economic conditions, and allow for participation in non-traditional products and markets. Because firms offering investments in hedge funds are providing investment advice, we supported the SEC hedge fund adviser registration rule³⁰ -- subsequently vacated by the D.C. Circuit Court of Appeals³¹ -- that would have sharply curtailed hedge fund advisers’ ability to avail themselves of the “private adviser” exemption from SEC registration under the Advisers Act. Consistent with our support of functional regulation, and despite the court decision vacating the rule, the IAA continues to support the registration of hedge fund advisers.

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

²⁸ Public Law No. 106-102.

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

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

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

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

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

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

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

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

Given the significant political impediments, as well as doubts as to whether a single regulator for all financial institutions would truly achieve greater investor protection for investment advisory clients, we question whether the Department should

expend a great deal of time and effort in this area. Instead, we respectfully suggest that the Department focus on issues (such as functional regulation) that present significant problems for investors and that have a greater likelihood of being addressed.

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

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

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

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

Principles-Based Regulation: The Advisers Act

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

³² The IAA takes no position at this time on the issues discussed in Sections 1.3.1, 1.3.2 or 1.3.3.

³³ See Sections 203 and 209, Advisers Act.

³⁴ Section 206(1), (2), and (3), Advisers Act.

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

As part of this regulatory scheme, investment advisers are subject to a strict fiduciary duty. This duty has been upheld by the U.S. Supreme Court³⁶ and reiterated by the SEC in various pronouncements over the years.³⁷ This fiduciary duty is one of the primary distinctions between investment advisers and others in the financial services industry.³⁸ As a fiduciary, “an investment adviser must at all times act in its clients’ best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions.”³⁹ Among obligations that flow from an adviser’s fiduciary duty are: (1) the duty at all times to place the interests of clients first; (2) the duty to have a reasonable basis for its investment advice; (3) the duty to seek best execution for client securities transactions where the adviser directs such transactions; (4) the duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines, and restrictions; (5) the duty to treat clients fairly; (6) the duty to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest; and (7) the duty to respect the confidentiality of client information.⁴⁰

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

Concern About Increasing “Rules-Based” Regulation

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

³⁵ Section 206(4), Advisers Act. The SEC also is given authority to exempt persons or transactions from the Advisers Act or regulations thereunder, “to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.” Section 206A, Advisers Act.

³⁶ *Capital Gains*, *supra* note 3, at 186.

³⁷ *See, e.g., In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

³⁸ Paul F. Roye, Director, Division of Investment Management, SEC, Remarks before the ICAA: 2000 and Beyond: SEC Priorities for the Investment Advisor Profession (Apr. 6, 2000).

³⁹ Lemke & Lins, *Regulation of Investment Advisers*, at 2-34 (2007).

⁴⁰ *See* IAA Standards of Practice.

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

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

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

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

⁴¹ *Supra* note 10.

⁴² 17 C.F.R. § 275.204A-1.

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

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

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

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

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

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

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

⁴⁴ *Supra*, notes 37-41.

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

⁴⁶ See Press Release, “Commission Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts,” Rel. No. 2007-95 (May 14, 2007).

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

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

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

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

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

⁴⁸ *Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosure*, SEC (Mar. 10, 2005) at 8.

⁴⁹ Last year, the IAA worked with the Coalition on Investor Education -- comprised of Consumer Federation of America, North American Securities Administrators Association, Investment Adviser Association, Financial Planning Association, and CFA Institute -- to publish an investor education brochure called "Cutting through the Confusion." After a meeting with the SEC's Office of Investor Education in October 2006, various links to the brochure were included on the SEC's web site. Linking the brochure on the web site was a positive first step in educating investors. Unfortunately, the links to this investor education piece have recently been removed. Reinstating references to the educational brochure would assist in providing helpful information to investors about issues they confront when engaging the services of an investment professional.

⁵⁰ *Supra* note 4.

⁵¹ The \$25 million threshold was intended to provide a bright line test for allocating regulatory responsibility of advisers between the SEC and the states, representing a rough cut between advisers that generally do business in interstate commerce and those that generally have more localized practices. The report accompanying the Senate-passed bill notes that the SEC "may also use its exemptive authority under the bill to raise the \$25 million threshold higher as it deems appropriate in keeping with the purposes of the Investment Advisers Act" and concurred in a recommendation of NASAA to review the appropriateness of this threshold at least every three years. S.Rpt. 104-293, p. 5 (June 26, 1996).

⁵² S.Rpt.104-293, pp. 3-4 (June 26, 1996).

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

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

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

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

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

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

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

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

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

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

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

Respectfully submitted,



David G. Tittsworth
Executive Director



Neil A. Simon
Vice President for Government
Relations

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

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