INVESTMENT ADVISER ASSOCIATION

August 2, 2018

Via Electronic Filing

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation (SEC Rel. No. IA-4889; File No. S7-09-18)

Dear Mr. Fields:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Commission's request for comment on "enhancing investment adviser regulation," which is part of its proposed interpretation regarding the standard of conduct for advisers.[2] The proposed interpretation is one of three Commission releases that is part of a package intended to address the standards of conduct for broker-dealers and investment advisers.[3] We commend the Commission for taking steps to address this complex and important investor protection issue. We will file a separate comment letter on the Reg BI Proposing Release, the Form CRS Proposing Release, and the Proposed Interpretation.[4]

We strongly urge the Commission not to consider imposing unnecessary and ill-fitting broker-dealer regulation on investment advisers as part of this critically important standard of conduct package. We believe the Commission should instead remain focused on raising the standard of conduct for broker-dealers to match investors' expectations regarding the advice they

[1] The IAA is a not-for-profit association dedicated to advancing the interests of SEC-registered investment advisers. The IAA's more than 650 member firms manage more than $20 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information, please visit our website: www.investmentadviser.org.

[2] *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers* ("Proposed Interpretation"); *Request for Comment on Enhancing Investment Adviser Regulation* ("Request for Comment"), SEC Rel. No. IA-4889 at 27 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

[3] *See Regulation Best Interest,* SEC Rel. No. 34-83062 (Apr. 18, 2018) ("Reg BI Proposing Release"), available at https://www.sec.gov/rules/proposed/2018/34-83062.pdf and *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles,* SEC Rel. No. 34-83063; IA-4888 (Apr. 18, 2018) ("Form CRS Proposing Release"), available at https://www.sec.gov/rules/proposed/2018/34-83063.pdf.

[4] Letter from Karen L. Barr, President and CEO, Investment Adviser Association, to Brent J. Fields, Secretary, SEC re: *Reg BI Proposing Release, Form CRS Proposing Release, and Proposed Interpretation*, will be available on our website under Publications, Comment Letters.

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receive.[5] The Commission has not explained how potential additional regulation of investment advisers would address this goal, nor has it provided adequate support for how it would benefit advisory clients. Accordingly, we write separately to express our views on the Request for Comment.

I. Introduction

The Commission raises questions relating to several areas "for potential harmonization of broker-dealer and investment adviser regulation."[6] The Commission identifies a few discrete areas—(1) financial responsibility regulations, (2) provision of account statements, and (3) federal licensing and continuing education—that the SEC staff addressed in its Section 913 Study where the Commission believes the "current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context."[7]

Commissioner Peirce observed that these types of requirements "would represent a paradigm shift" in the principles-based way that the Commission regulates investment advisers.[8] We agree. We are concerned that "harmonization" of investment adviser and broker-dealer regulation would result in an overly prescriptive, check-the-box regulatory regime that does not fit advisers' businesses and is not consistent with the flexible principles-based fiduciary duty for advisers.[9] Accordingly, we recommend the Commission refrain from any rulemaking in these areas.

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[5] *See also Statement at the Open Meeting on Standards of Conduct for Investment Professionals*, SEC Commissioner Hester M. Peirce (Apr. 18, 2018) ("Commissioner Peirce Statement"), available at https://www.sec.gov/news/public-statement/statement-peirce-041818 (the Request for Comment is a "distraction" from the current focus on addressing standards of conduct for broker-dealers and advisers).

[6] Request for Comment at 27. *See also,* Reg BI Proposing Release at 62, n.121.

[7] Request for Comment at 27. *See also,* Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011) ("Section 913 Study"), available at www.sec.gov/news/studies/2011/913studyfinal.pdf.

[8] Commissioner Peirce Statement, *supra* note 5.

[9] *See* Statement of David G. Tittsworth, Executive Director and Executive Vice President, Investment Adviser Association, Enhancing Investor Protection and the Regulation of Securities Markets – Part II, before the Senate Committee on Banking, Housing and Urban Affairs (Mar. 26, 2009) ("IAA 2009 Testimony") at 11-13 and 15-17, available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/Testimony_032609.pdf; Statement of David G. Tittsworth, Executive Director and Executive Vice President, Investment Adviser Association, Hearing on Regulation and Oversight of Broker-Dealers and Investment Advisers, before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives (Sept. 13, 2011) ("IAA 2011 Testimony") at 14-16, available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/110913tstmny.pdf; Letter from David G. Tittsworth, Executive Director, Investment Adviser Association, to Elizabeth M. Murphy, Secretary, SEC re: *Request for Data and Other Information*, Rel. No. 34-69013; IA-3558 (July 3, 2013) ("IAA 2013 Letter"), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/130703cmnt.pdf.

In particular, the broker-dealer regulations suggested in the Request for Comment are inapt for investment advisers, would not effectively address the Commission's concerns, and are unnecessarily duplicative or burdensome. The Commission should recognize that: (i) investment advisers' business models and activities differ significantly from those of broker-dealers; (ii) given those differences, financial responsibility rules are inappropriate and unnecessary for advisers; (iii) account statements are already provided to advisory clients; and (iv) federal licensing and continuing education are unnecessary due to the current compliance framework applicable to investment advisers, as well as state licensing of investment adviser representatives. We discuss our comments below.

II. Investment Advisers' Business Models Differ Significantly from those of Broker-Dealers

Broker-dealers and investment advisers have fundamentally different business models and engage in a different range of activities. Broker-dealers offer a wide variety of services, including selling investment products such as securities, variable annuities, and interests in limited offerings or private placements; effecting securities transactions; making markets; margin lending; securities lending; taking custody of client funds or securities; executing trades; acting as a market maker, dealer, syndicator or underwriter; engaging in stock exchange floor activities; and providing investment advice that is supposed to be solely incidental to those activities.[10]

Advisers, on the other hand, engage in an agency business of providing portfolio management and investment advice to their clients under a broad, principles-based fiduciary duty. They provide investment advisory services in exchange for a fee, take no balance sheet risk with respect to their clients' investment performance, and may not use client assets for their own purposes.[11] Advisers are not permitted to maintain physical custody of client assets. Instead, they are required to use qualified custodians (*i.e.*, banks, registered broker-dealers, and registered futures commission merchants) under the Investment Advisers Act of 1940 ("Advisers Act") custody rule.

Broker-dealer regulation under the Securities Exchange Act of 1934 ("Exchange Act") and investment adviser regulation under the Advisers Act recognize the fundamentally different business models of these financial services companies.[12] Broker-dealer regulations are geared

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[10] For a discussion of broker-dealer services, see Reg BI Proposing Release at 6, nn.1-3 (citing Section 913 Study at 9-10).

[11] *See* Joint Letter from Karen L. Barr, President and CEO, Investment Adviser Association and Timothy Cameron, Head of Asset Management, SIFMA AMG to Financial Stability Oversight Council ("FSOC") re: *FSOC Notice Seeking Comment on Asset Management Products and Activities*, Docket No. FSOC-2014-0001 (Mar. 25, 2015) at 58, available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/150325cmnt.pdf.

[12] For a comparison of the different regulatory frameworks governing investment advisers and broker-dealers, see Letter from David G. Tittsworth, Executive Director, Investment Adviser Association to Elizabeth M. Murphy,

toward sales of products and market-related activity, with a detailed, prescriptive rule set designed to address broker-dealers' broad range of activities and the role they play in holding customer assets. The Advisers Act regulatory regime is specifically geared toward portfolio management and other investment advisory activities and provides a flexible principles-based framework that permits the broad diversity of advisory firms to tailor their compliance programs to fit their specific activities. The Advisers Act is appropriately tailored to—and provides robust investor protection for—investment advisory activities. To suggest that broker-dealer regulation should apply to investment advisers is both unnecessary and misdirected.

III. Financial Responsibility Rules are Inapt for Advisers

Given the different business models, broker-dealer financial responsibility regulations are not appropriate for registered investment advisers because: (i) investment advisers' businesses do not present the primary risks that broker-dealer financial responsibility rules are intended to address; (ii) financial responsibility regulations would not address the Commission's stated concerns; and (iii) current adviser rules adequately address the safety of client assets in light of advisers' business models. Furthermore, the significant costs that would be imposed by these rules would far outweigh any benefits.

A. Investment Advisers' Businesses Do Not Present the Primary Risks that Financial Responsibility Rules Are Intended to Address

Broker-dealer financial responsibility requirements are important for broker-dealers because they maintain custody of customer assets,[13] act as principal, and engage in market making, underwriting, trade settlement, clearing, and other activities integral to the functioning of the securities markets. Given this business, broker-dealer financial responsibility rules are intended to protect customers and creditors from losses and delays that can occur when a broker-dealer fails.[14]

Secretary, SEC re: *Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, Rel. No. IA-3058 (Aug. 30, 2010), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/100830cmnt_BDIA.pdf.

[13] *See SEC Press Release, SEC Adopts Rules to Increase Protections for Investors With Assets Being Held By Broker-Dealers* (July 31, 2013) ("SEC 2013 Press Release"), available at https://www.sec.gov/news/press-release/2013-141.

[14] *Id. See also, Joint Report of SEC and CFTC on Harmonization of Regulation* (Oct. 16, 2009) at 33 (citations omitted), available at https://www.sec.gov/news/press/2009/cftcjointreport101609.pdf (Section 15(c)(3)(A) of the Exchange Act provides that the Commission must "prescribe safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances" requiring the maintenance of reserves with respect to customers' deposits or credit balances, and minimum financial responsibility requirements for all brokers and dealers).

For example, the net capital rule is designed to ensure that a broker-dealer under financial stress can satisfy its liabilities.[15] The customer protection rule requires that broker-dealers segregate assets so that they can be returned to customers if the broker-dealer becomes insolvent.[16] These rules are necessary because broker-dealers hold client funds and engage in proprietary business activities. Similarly, the annual audit requirement is relevant for broker-dealers because a broker-dealer holds client assets and a broker-dealer's financial stress or insolvency can cause customer loss. Like net capital, the purpose of requiring a financial statement would be to determine whether an entity would be solvent as a going concern.

Investment advisers' activities do not present these risks. Among the many differences in business risk, it is most significant that: (i) investment advisers do not hold client assets; and (ii) the insolvency or failure of an adviser does not put client assets at risk.

1. Investment Advisers Do Not Hold Client Assets

Importantly, investment advisers are not permitted to hold client assets. Instead, under the Advisers Act custody rule (Rule 206(4)-2), a qualified custodian must maintain advisers' clients' funds and securities in a separate account for each client under that client's name, or in accounts that contain only the clients' funds and securities, under the advisory firm's name as agent or trustee for the clients.[17] Qualified custodians under the rule include the types of financial institutions to which clients and advisers customarily turn for custodial services, including banks, registered broker-dealers, and registered futures commission merchants, and these financial institutions' custodial activities are subject to regulation and oversight specifically designed for this activity.[18] Thus, investment advisers are not permitted to hold client funds or securities and are prohibited from commingling proprietary funds and client funds.

2. The Insolvency or Failure of an Investment Adviser Does Not Place Client Assets at Risk

Capital requirements for broker-dealers help to manage the orderly liquidation of a broker-dealer and the transfer of customer assets to another broker-dealer. In contrast, investment

[15] *See, e.g.*, SEC 2013 Press Release, *supra* note 13.

[16] *Id.*

[17] Advisers Act Rule 206(4)-2(a)(1). *Custody of Funds or Securities of Clients by Investment Advisers*, SEC Rel. No. IA-2968 (Dec. 30, 2009) ("Custody Rule Release"), available at https://www.sec.gov/rules/final/2009/ia-2968.pdf. *See also*, *SEC Investor Bulletin on Custody* (Mar. 4, 2013), available at https://www.sec.gov/investor/alerts/bulletincustody.htm.

[18] Advisers Act Rule 206(4)-2(a)(3). *See also*, Custody Rule Release *supra* note 17 at 4, n.5 (citing *Custody of Funds or Securities of Clients by Investment Advisers Proposal*, SEC Rel. No. IA-2876 (May 20, 2009)).

advisers do not accept deposits, hold client assets, or clear or settle trades.[19]

Contrary to a broker-dealer insolvency situation, clients do not risk loss of their assets when their investment adviser goes out of business or becomes insolvent. Advisers routinely enter and exit the market, and as agents, routinely accommodate the transfer of client assets to another adviser, without any negative impact on the client. Indeed, the adviser relationship contemplates that the client may choose to change advisers at any time by terminating the contract. In either scenario, the client's assets often do not move. Rather, there is simply a change in the identity of the firm or individual providing advice. The failure or insolvency of an adviser does not put its clients' assets at risk, because the clients' funds are required to be maintained separately from the assets of the adviser. Advisory clients retain direct and sole ownership of the assets under management and those assets are typically held at an independent qualified custodian on behalf of the client.[20] There is absolute separation between an investment adviser's assets and liabilities and the assets and liabilities of a client fund or account the adviser manages.[21] In addition, existing regulations prohibit investment advisers from commingling client assets with proprietary assets in the investment adviser's name or using the assets of one client to meet the obligations of another client of the investment adviser.

Furthermore, based on the structure of fund investment vehicle clients (such as limited partnerships or limited liability companies), an investment adviser's creditors do not have recourse to fund assets.[22] Similarly, creditors of an adviser do not have recourse to separate account assets. Thus, investor assets are typically not at risk if an adviser encounters financial difficulties and therefore capital requirements would not provide greater protection for client funds.

As the Commission noted in 2016:

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[19] Presumably because of these differences, Congress has reconsidered the Advisers Act as part of the process of reauthorizing the SEC roughly every four or five years and has never authorized the SEC to adopt minimum capital requirements as a prerequisite for registration as an investment adviser. Congress amended the registration requirement provisions set forth in Advisers Act Section 203A as recently as 2010 (the Dodd-Frank Act) and did not determine that a statutory requirement for net capital was appropriate. *See* Request for Comment at 36, n.84 (evidencing lack of congressional consideration of capital requirements for advisers since 1976).

[20] *FSOC, Notice Seeking Comment on Asset Management Products and Activities*, Docket No. FSOC-2014-0001, 79 Fed. Reg. 77488, 77489 at n.3 (Dec. 24, 2014), available at https://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-30255.pdf. *See also*, Letter from Karen L. Barr, General Counsel, Investment Adviser Association, to National Futures Association re: *CPO/CTA Capital Requirements and Customer Protection Measures* (Apr. 11, 2014) ("IAA 2014 Letter"), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/NFA_Comment_Letter_Final.pdf.

[21] *See* IAA 2014 Letter, *supra* note 20.

[22] *Id.*

> In the normal course of business, it is our understanding that advisers routinely transition client accounts without a significant impact to themselves, their clients, or the financial markets. We believe that much of this is largely attributable to the agency relationship of advisers managing the assets on behalf of their clients and the regulatory framework supporting this relationship whereby advisory client assets for which the adviser has custody are required to be held at a qualified custodian, such as a bank or broker-dealer. Because client assets custodied by an adviser must be held at a qualified custodian and segregated from the adviser's assets, we have observed that transitioning accounts from one adviser to another can largely be a streamlined process that in many cases may not involve the physical movement or sale of assets. Pooled investment vehicle clients generally have the ability to terminate the advisory contract of the adviser or remove the governing body that may provide advisory services (*e.g.*, general partner or managing member) and appoint a new adviser or governing body if they so desire, while separate account clients can generally terminate the advisory contract and appoint a new adviser to manage their assets, all while their assets are typically maintained at a qualified custodian.[23]

Because an investment adviser acts merely as an agent in managing assets on behalf of clients, clients' assets are protected even if the adviser becomes unable to provide services. The use of custodians to hold client assets facilitates the substitution of investment advisers and reduces risk. The vast majority of investment advisers—more than 96 percent—have independent qualified custodians that are unaffiliated with the adviser.[24]

As a result, in the ordinary course, clients may easily transfer advisory authority over separately managed accounts to another investment adviser simply by removing trading discretion from one adviser and granting it to another. Like all businesses, investment advisers may fail or close from time to time; however, those failures do not deprive clients of essential or irreplaceable services or access to essential records.[25] At the same time, financial responsibility

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[23] *Adviser Business Continuity and Transition Plans Proposal*, SEC Rel. No. IA-4439 (June 28, 2016) at 19-20, available at https://www.sec.gov/rules/proposed/2016/ia-4439.pdf.

[24] *See 2017 Evolution Revolution: A Profile of the Investment Adviser Profession, by IAA and NRS* ("2017 Evolution Revolution") at 26, available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/Evolution_Revolution_2017.pdf (only 71 of 12,172 SEC-registered advisers reported acting as a qualified custodian in connection with their advisory services and 372 advisers reported that a related person acts as a qualified custodian). Advisers that have an affiliated qualified custodian are subject to additional requirements in order to safekeep client assets, including that the accountant conducting the surprise examination must be registered with, and subject to inspection by, the Public Company Accounting Oversight Board (PCAOB) and that the adviser must obtain a yearly written internal control report prepared by an independent public accountant. *See* Advisers Act Rule 206(4)-2(a)(6).

[25] *See* Letter from Robert C. Grohowski, General Counsel, Investment Adviser Association to Brent J. Fields, Secretary, SEC re: *Adviser Business Continuity and Transition Plans*, SEC Rel. No. IA-4439 (Sept. 6, 2016),

rules would impose increased costs on advisers, with no clear corresponding benefit.[26]

B. Financial Responsibility Rules Would Not Address the Commission's Stated Concerns

The Commission posits that financial responsibility rules, including net capital and fidelity bonding, could serve to provide clients with recovery for their losses in cases of serious fraud. The Commission seeks comment on the frequency and severity of client losses due to investment advisers' inability to satisfy a judgment or otherwise compensate a client for losses due to the investment adviser's wrongdoing.

We do not have access to data regarding instances where an adviser was unable to satisfy a judgment or otherwise compensate a client for losses due to any wrongdoing.[27] However, we note that more than 25% of broker-dealer customer arbitration awards issued in 2016 under the broker-dealer financial responsibility regime went unpaid.[28] Thus, we are not aware of any evidence that these existing rules are effective at addressing unpaid judgments. Further, such unpaid judgments likely involve egregious behavior or outright fraud.[29] Given the blatant disregard for applicable regulatory requirements exhibited by individuals and firms in these cases, financial responsibility requirements would likely not prevent bad actors from misappropriating assets or provide additional means of recovery. As a result, the measures under consideration are not likely to be particularly effective in addressing the SEC's concerns but would instead impose significant costs on investment advisers, with a disproportionate impact on smaller advisers as discussed below.

With respect to fidelity bonds more specifically, the Commission has provided no data regarding the efficacy of current requirements. Fidelity bonding is already required under ERISA Section 412 and Section 17(g) and Rule 17g-1 under the Investment Company Act of 1940

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available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/160906cmnt.pdf.

[26] For the same reasons, we would oppose any "reserve" or minimum capital requirements.

[27] It may be very difficult to detect the actual amount based on Commission reports. For example, GAO noted that in fiscal year 2014, the Commission recorded approximately $3.7 billion of new disgorgement and penalty accounts receivables. However, as of September 30, 2014, the Commission's disgorgement and penalties accounts receivable balance, net of an allowance for uncollectible amounts, was $381 million. The Commission's custodial revenue collected from disgorgement and penalties and transferred to the general fund of the Treasury during fiscal year 2014 was $825 million. *See GAO, Financial Audit: Securities and Exchange Commission's Fiscal Years 2014 and 2013 Financial Statements* (Nov. 17, 2014) at 71, available at https://www.gao.gov/assets/670/667324.pdf.

[28] *See FINRA Discussion Paper - FINRA Perspectives on Customer Recovery* (Feb. 8, 2018) at 6-7, available at http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf?utm_source=MM&utm_medium=email&utm_campaign=NewsRelease_020818_FINAL (noting that the amount results in about 11% of the total unpaid arbitration awards issued in 2016).

[29] *See* IAA 2014 Letter, *supra* note 20 (discussing National Futures Association actions).

("Investment Company Act").[30] Most registered funds include on their fidelity bonds advisory personnel who provide services to the fund.[31] This should present an opportunity for the Commission to gather and analyze data regarding whether these requirements have provided recovery for defrauded customers. For example, our anecdotal evidence suggests that few if any fidelity bond claims have been filed by ERISA or registered fund clients of advisers over the past 20 years. Moreover, in cases of serious misconduct, the insurer may contest coverage on a variety of grounds.[32]

In 2003, the Commission asked for similar comment on whether fidelity bonds provide a source of compensation for advisory clients who are victims of fraud or embezzlement by advisory personnel.[33] Responses highlighted the significant costs and other negative implications of fidelity bonding.[34] In response to the 2003 proposal, as we do today, we submitted that the Commission has not demonstrated that any benefit of fidelity bonding would outweigh the costs.[35] Indeed, costs associated with all of these financial responsibility regulations on registered investment advisers could be a barrier to entry to new firms, with no meaningful benefit, and could marginally decrease competition among advisers and have particular impact on smaller firms, to the possible detriment of clients. The vast majority of SEC-registered investment

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[30] Section 17g(1) of the Investment Company Act provides that the Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (unless the officer or employee has such access solely through his position as an officer or employee of a bank) be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts, which the Commission prescribes in Rule 17(g)-1.

[31] *See* Letter from Investment Company Institute to Jonathan G. Katz, Secretary, SEC re: *Compliance Programs of Investment Companies and Investment Advisers Proposal,* SEC Rel. No. IC-25925; IA-2107 (Apr. 17, 2003), available at https://www.sec.gov/rules/proposed/s70303/s70303-15.pdf.

[32] *See* Letter from David G. Tittsworth, Executive Director, Investment Adviser Association, to Jonathan G. Katz, Secretary, SEC re: *Compliance Programs of Investment Companies and Investment Advisers Proposal*, SEC Rel. No. IC-25925, IA-2107 (Apr. 17, 2003) ("IAA 2003 Letter"), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/letterscompendium-2003.pdf.

[33] *See Compliance Programs of Investment Companies and Investment Advisers Proposal,* SEC Rel. No. IC-25925; IA-2107 (Feb. 5, 2003), available at https://www.sec.gov/rules/proposed/ic-25925.htm. Many commenters urged the Commission not to adopt a fidelity bonding requirement. *See Compliance Programs of Investment Companies and Investment Advisers, SEC Staff Summary of Comments on Proposed New Rules 38a-1 under the Investment Company Act and 206(4)-7 under the Investment Advisers Act, and Proposed Amendments to Rule 204-2 under the Investment Advisers Act* (Nov. 20, 2003), available at https://www.sec.gov/rules/extra/s70303summary.pdf (discussing comments).

[34] *See, e.g.,* Letter from Financial Engines to Jonathan G. Katz, Secretary, SEC re: *Compliance Programs of Investment Companies and Investment Advisers Proposal,* SEC Rel. No. IC-25925; IA-2107 (Apr. 18, 2003), available at https://www.sec.gov/rules/proposed/s70303/financial041803.htm.

[35] IAA 2003 Letter, *supra* note 32.

advisers are small businesses,[36] which have been negatively impacted by the cumulative cost of increased regulation over the past several years. The Commission should carefully consider the interests of these small businesses and their clients—many of whom presumably have deliberately chosen to work with smaller shops—before imposing requirements that would impose significant costs without evidence of significant benefit.

C. Current Rules Adequately Address the Safety of Client Assets

The current regulatory regime for investment advisers appropriately addresses the relevant risks presented by advisers' business models. As discussed throughout the Commission's rulemaking package, investment advisers are subject to an overarching fiduciary duty that requires them to act in their clients' best interests. In addition, the custody rule is intended to protect clients from theft or misuse of their assets by advisers that hold or have authority to obtain possession of them in connection with advisory services. When the Commission amended the custody rule in 2009, it stated its intent that the custody rule deter and detect fraud by registered investment advisers, noting that:

> We believe these amendments, together with the guidance for accountants, will provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers' financial reverses. We acknowledge that no set of regulatory requirements we could adopt will prevent all fraudulent activities by advisers or custodians. We believe, however, that this rule, together with our examination program's increased focus on the safekeeping of client assets, will help deter fraudulent conduct, and increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized.[37]

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[36] In 2017, 56.8 percent of the over 12,000 SEC-registered advisory firms reported that they employ 10 or fewer non-clerical employees and 87.4 percent of the firms reported employing 50 or fewer individuals. *See* 2017 Evolution Revolution, *supra* note 24.

[37] Custody Rule Release, *supra* note 17 at 6. Moreover, if an investment adviser has constructive custody of a fund client's assets under the rule (*i.e.*, as a general partner of a fund), client assets must be verified pursuant to the custody rule, either through a surprise examination by an independent public accountant or as part of a generally accepted accounting principles (GAAP) audit from a PCAOB-registered and inspected firm. These audited fund financial statements must then be distributed to client fund investors, and the accounting firm serves as an independent third party to verify client assets and to protect against their misappropriation. To verify assets in the surprise exam, SEC guidance states that accountants should obtain records that detail the client assets and identify the qualified custodians. The SEC also has provided guidance that the accountants should perform a comprehensive review on sample client accounts, which includes reviewing the "purchases, sales, contributions, withdrawals and any other debits or credits" to such accounts, and confirm the records with the custodian, since the time of the prior examination. After conducting the surprise examination, the independent public accountant must file a certificate on Form ADV-E with the SEC stating that it has examined the funds and securities and describing the nature and extent of the examination. Auditors are required to verify assets by, among other methods, confirmation with the issuer of a security or with the counterparty to a derivative, confirmation of settled transactions with a broker-dealer or counterparty, physical inspection of a security or derivative contract, reading executed partnership or similar agreements, inspecting underlying agreements, and other forms of supporting documents. *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the*

In addition to the custody rule, the compliance program rule (Rule 206(4)-7) under the Advisers Act requires advisers to adopt and implement policies and procedures reasonably designed to prevent violations by the firm and its supervised persons. As noted in the rule's adopting release, the Commission stated its expectation that an adviser's policies and procedures at a minimum would address a number of items, including "[s]afeguarding of client assets from conversion or inappropriate use by advisory personnel."[38] This regulatory obligation imposes important protections for advisers' clients.

Further, the safety of assets and custody are a core examination priority of the Commission staff for investment advisers.[39] And the Commission conducts examinations of broker-dealer custodians and transfer agents, which provide additional safeguards of client funds and securities. Broker-dealers that maintain custody of a customer's securities and cash are also subject to strict requirements under the Exchange Act that are designed to protect and account for these assets.[40]

Finally, investment advisers must disclose on Form ADV Part 1 (Item 11) and Part 2A (Items 18) disciplinary history, and, if an adviser has discretion or requires prepayment of more than $1,200 fees in advance, the adviser must disclose any financial condition that is reasonably likely to impair its ability to meet contractual commitments to clients during the year in its Form ADV Part 2A.[41] If the adviser has been the subject of a bankruptcy petition at any time during the past ten years, the adviser must disclose that and the date the petition was first brought, and the current status.[42] These items must be updated and provided to clients if responses to the Items become materially inaccurate at any time during the year.

IV. Additional Regulation Regarding Account Statements is Unnecessary and Duplicative

The Commission seeks comment on whether it should require registered investment advisers to provide account statements, either directly or via the client's custodian. As

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Investment Advisers Act of 1940, SEC Rel. No. IA-2969 (Dec. 30, 2009), available at https://www.sec.gov/rules/interp/2009/ia-2969.pdf. *See also*, IAA 2014 Letter, *supra* note 20.

[38] *Compliance Programs of Investment Companies and Investment Advisers*, SEC Rel. Nos. IA-2204; IC-26299 (Dec. 17, 2003), available at https://www.sec.gov/rules/final/ia-2204.htm.

[39] The Commission has significantly increased its ranks of adviser examiners and its ability to leverage data and technology in recent years, resulting in increased adviser examinations. SEC examiners focus closely on advisers' policies and procedures related to maintaining the safety of client assets and reconciliation of adviser and custodian data.

[40] *See* SEC 2013 Press Release, *supra* note 13.

[41] *See* Item 18(B) of Form ADV, Part 2A.

[42] *See* Item 18(C) of Form ADV, Part 2A.

justification, the Commission posits that clients do not already receive information about fees and costs. This concern is without foundation.

First, clients currently receive statements specifying the actual advisory fees they pay in one of two ways: (i) the adviser bills the client directly for advisory fees, or (ii) more commonly, the client's custodian provides a quarterly account statement in cases where the adviser directly debits advisory fees.[43] The custodial account statements specify the dollar amounts charged for advisory fees and brokerage fees charged to the client. In fact, the Commission previously made a policy judgment that requiring the client's custodian to send account statements is more protective of investors than having the adviser provide them.[44] The Commission provides no explanation of why its views may have changed. Indeed, the SEC stated in its custody rule release that, "direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients."[45] The Commission went so far as to require advisers that voluntarily chose to send account statements to warn clients that they should carefully compare the statement received from the adviser against the one they receive from the custodian.[46]

Second, clients already have documentation or receive disclosure about an investment adviser's fees. When the client enters into an investment management (or investment advisory agreement), the advisory fees to be charged on the assets under management are included. Investment advisers also provide clients fulsome information about the fees and expenses they

[43] Advisers Act Rule 206(4)-2. In addition, advisers (or their designees) that are the sponsor of a managed account program relying on the safe harbor in Investment Company Act Rule 3a-4 (discretionary investment advisory programs) must provide each client with a statement, at least quarterly, containing a description of all activity in the client's account during the period, including all transactions made on behalf of the account, all contributions and withdrawals made by the client, all fees and expenses charged to the account, and the value of the account at the beginning and end of the period.

[44] Advisers deemed to have custody of client assets must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends clients an account statement, at least quarterly, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period. Advisers Act Rule 206(4)-2(a)(3).

[45] Custody Rule Release, *supra* note 17 at 7.

[46] Advisers Act Rule 206(4)-2(a)(2). In addition, broker-dealers are required to provide account statements to customers, including clients of advisers. Under the broker-dealer account statement rules, broker-dealers must send, at least once every calendar quarter, a statement of account containing a description of any securities, positions, money balances, or account activity, including advisory fees paid, to each customer whose account had a securities position, money balance, or account activity during the period since the last statement was sent to the customer. These rules provide a key safeguard for customers by requiring that they receive information concerning securities positions and other assets held in their accounts on a regular basis, which they can use to identify discrepancies and monitor the performance of their accounts. *See Broker-Dealer Reports,* SEC Rel. No. 34-70073 (July 30, 2013), available at https://www.sec.gov/rules/final/2013/34-70073.pdf. *See also, Financial Responsibility Rules for Broker-Dealers*, SEC Rel. No. 34-70072 (July 30, 2013), available at https://www.sec.gov/rules/final/2013/34-70072.pdf (importation of former Rule 15c3-2 requirements into asset segregation Rule 15c3-3(j)(1) and Rule 10b-10 (confirmation of transactions)).

can expect to pay in Form ADV, Part 2A, Item 5. Under Item 5, an investment adviser must disclose at the time of the relationship (and annually, if there is a change) how the adviser is compensated for advisory services and state its fee schedule. Advisers must also describe whether they deduct fees from clients' assets or bill clients for fees incurred and how often they bill clients or deduct fees. Advisers must also describe what other expenses the client will pay.

Accordingly, the Commission has provided no compelling benefit to requiring registered investment advisers to provide account statements.

V. Federal Licensing and Continuing Education Requirements Are Unnecessary and Inappropriate

The Commission seeks comment on whether it should require federal licensing and continuing education requirements for personnel of SEC-registered investment advisers. We do not believe that additional requirements are necessary or appropriate. The Commission's request fails to appreciate that all adviser personnel are subject to a range of compliance requirements and already receive training on the laws, regulations, and fiduciary obligations applicable to advisers. Furthermore, advisory personnel who engage with retail clients are also subject to state licensing and qualification requirements.

Investment advisers must supervise and train their employees under both Advisers Act Section 203(e)(6) and the compliance program rule. The statutory requirement to supervise advisory personnel under Section 203(e)(6) and the compliance program rule separately require advisers to adopt and implement written policies and procedures reasonably designed to prevent violation—by the adviser and its supervised persons—of the Advisers Act and the rules thereunder. Advisers are obligated to ensure appropriate supervision of their personnel, and as part of their compliance program requirements, generally require all personnel when hired, and at least annually thereafter, to receive training covering the firm's policies and procedures, including code of ethics and the firm's fiduciary obligations to clients, and to certify that they understand those obligations. Many firms conduct topical training in areas relevant to the firms' business, in addition to the more generalized compliance training.

In addition to the federally mandated compliance program and requirement for supervision, states license and impose examination or competency requirements on investment adviser representatives (*i.e.*, advisory personnel who provide advice to retail clients on behalf of SEC-registered investment advisers). All but one state (New York) require licensing of IARs with an office in the state and that they pass the Series 65 Uniform Investment Adviser Law Examination (or equivalent waiver). The exam covers economic and business information, investment vehicle characteristics, client investment recommendations and strategies, and legal requirements. Given the requirements currently in place, we believe that a second (or even third) layer of costly[47] requirements at the federal level is not necessary for these advisory personnel.[48]

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[47] In connection with the 2013 round of standard of conduct comments, Charles Schwab & Co. conducted a survey of 834 RIAs regarding the cost of imposing broker-dealer rules on investment advisers – including licensing and examination requirements. Survey respondents estimated an average of $64,000 to set up the program and $37,400

Moreover, the North American Securities Administrators Association (NASAA) is currently undertaking a survey of stakeholders to determine whether and how to develop a responsive and relevant continuing education program for investment adviser representatives. After considering the survey results and other feedback, NASAA and its members may adopt a NASAA Model Rule regarding continuing education for investment adviser representatives (IAR-CE).[49] At a minimum, the Commission should assess the results of NASAA's comprehensive study of continuing education requirements before determining whether to proceed on a duplicative track.

In addition to suggesting the imposition of new requirements, the Commission also asks whether a new federal layer of such requirements would provide "better visibility into qualifications and education of adviser personnel."[50] The Commission fails to acknowledge that advisers already are required to provide clients with a description of the qualification, education, business background, disciplinary history, and additional compensation (including sales awards) for personnel providing advice for each client.[51] This information is required to be affirmatively provided to each client for whom the advisers' personnel are giving or formulating advice, and is far more relevant to a client assessing the qualification of such personnel than passing an exam. There is no such counterpart for broker-dealers.

Finally, we note that the Commission may not have legal authority to adopt licensing requirements for personnel of investment advisory firms. Nor does the Commission have the infrastructure or resources to administer such a program.[52] We strongly oppose—for the many reasons we have previously stated—the Commission turning to FINRA to administer the program.[53] We continue to believe that the SEC is best positioned to regulate the principles-based

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annually to maintain it. *See* Letter from Christopher Gilkerson, Charles Schwab & Co., Inc., to Elizabeth M. Murphy, Secretary, SEC re: *Request for Data and Other Information, Duties of Brokers, Dealers and Investment Advisers*, SEC Rel. No. 34-69013; IA-3558 (July 5, 2013), available at https://www.sec.gov/comments/4-606/4606-3137.pdf.

[48] Indeed, the purpose of the National Securities Markets Improvement Act of 1996 (NSMIA) was to eliminate duplicative regulation. *See Rules Implementing Amendments to the Investment Advisers Act of 1940*, SEC Rel. No. IA-1633 (May 15, 1997), available at https://www.sec.gov/rules/final/ia-1633.txt.

[49] *See* NASAA Survey Regarding Continuing Education for Investment Adviser Representatives, available at http://www.nasaa.org/industry-resources/investment-advisers/nasaa-survey-regarding-continuing-education-for-investment-adviser-representatives/.

[50] Request for Comment at 30.

[51] Form ADV, Part 2B (Brochure Supplement).

[52] Section 913 Study, *supra* note 7 at 138.

[53] We have consistently opposed the imposition of a self-regulatory organization (SRO) on investment advisers, and in particular, FINRA, due to the lack of accountability, transparency, excessive costs and burdens, and a check-the-box regulatory framework that is inappropriate for the diverse and principles-based regulatory framework applicable

fiduciary business of registered advisers, and that the requirements applicable to broker-dealers are neither appropriate nor necessary additions to that regulatory framework.

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We appreciate the Commission's consideration of our comments and would be happy to provide any additional information that may be helpful. Please contact the undersigned or Gail C. Bernstein, General Counsel, at (202) 293-4222 if we can be of further assistance.

Respectfully Submitted,

Karen L. Barr

Karen L. Barr
President and CEO

cc: The Honorable Walter J. Clayton, Chairman
The Honorable Kara M. Stein, Commissioner
The Honorable Robert J. Jackson, Jr., Commissioner
The Honorable Hester M. Peirce, Commissioner
Dalia Blass, Director, Division of Investment Management
Brett Redfearn, Director, Division of Trading and Markets

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to advisers. *See* IAA 2009 Testimony, *supra* note 9 at 11-13 and 15-17; IAA 2011 Testimony, *supra* note 9 at 14-16; IAA 2013 Letter, *supra* note 9.