MANAGED FUNDS ASSOCIATION

AIMA

August 7, 2018

Mr. Brent J. Fields, Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: **Responses to Requests for Comment Regarding Areas of Enhanced Investment Adviser Regulation Provided in the Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers (File No. S7-09-18)**

Dear Mr. Fields:

Managed Funds Association[1] ("MFA") and the Alternative Investment Management Association[2] ("AIMA") (collectively, the "Associations") appreciate the opportunity to respond jointly to the interpretative guidance identified in the above file reference, which was published by the Securities and Exchange Commission ("Commission") on April 18, 2018 (the "Interpretation").[3]

In response to the Commission's requests for comment on areas of enhanced investment adviser regulation, for the reasons described below, the Associations do not believe that it is necessary or appropriate for the Commission to propose or adopt regulations mandating net capital, fidelity bonding or similar requirements for investment adviser representatives, account statement delivery requirements, or federal licensing and continuing education requirements for investment advisers. With respect to the potential net capital requirements in particular, the Associations

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1 MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

2 AIMA is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council ("ACC") to help firms focused in the private credit and direct lending space. The ACC currently represents over 100 members that manage $350 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

3 *See* Investment Advisers Act Release No. 4889 (April 18, 2018), 83 F.R. 21203 (May 9, 2018).

believe that such requirements would offer little in the way of investor protection and impose significant burdens on the investment adviser community, which are likely to increase costs on or limit the options available to clients who invest in capital markets with the professional assistance of an investment adviser.

The Associations note that we have submitted a companion comment letter to the Commission responding to each of the Proposed Regulation Best Interest (File No. S7-07-18), Proposed Form CRS Relationship Summary (File No. S7-08-18), and the Interpretation.[4]

I. Requirements Relating to Net Capital, Fidelity Bonds and Audited Financial Statements

In the Interpretation, the Commission notes that broker-dealers are subject to a comprehensive financial responsibility program, which includes: (i) net capital requirements;[5] (ii) requirements to segregate client assets;[6] (iii) membership in Securities Investor Protection Corporation (including insurance of customer accounts up to defined minimums);[7] and (iv) fidelity bond coverage requirements.[89] The Commission initially adopted these requirements in the 1970s in response to a congressional directive to strengthen the financial responsibility requirements for broker-dealers that hold securities and cash for customers or have unsubordinated liabilities to customers and trading counterparties.[10] The Associations appreciate the questions raised by the Commission; however, the Associations feel strongly that applying these broker-dealer requirements to investment advisers is neither warranted by a compelling policy interest nor an economically efficient means of promoting investor protection.

Congress and the Commission imposed protections such as the uniform net rule[11] and the customer protection rule,[12] in response to clear evidence of market failure that directly impacted customers. The Paper Work Crisis caused broker-dealers to fail and created customer losses.[13] The SEC documented these failures in the *Study of Unsafe and Unsound Practices of Brokers and Dealers*, (1971). Based on this documented record of failure, Congress enacted the Securities Investor Protection Act of 1970 and the Securities Acts Amendments of 1975. There is no equivalent record

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4 *See* Securities Exchange Act Release No. 83062 (April 18, 2018), 83 F.R. 21574 (May 9, 2018) ("Regulation Best Interest"); Investment Advisers Act Release No. 4888 (April 18, 2018), 83 F.R. 21416 (May 9, 2018) ("CRS Regulation"); Interpretation, *supra* note 3.

5 *See* 17 C.F.R. 240.15c3-1.

6 *See* 17 C.F.R. 240.15c3-3.

7 *See* 15 U.S.C. §78aaa-*lll*.

8 See FINRA Rule 4360.

9 Interpretation, *supra* note 3, at 21213.

10 *See*, e.g., SEC Release 34-11497 (June 26, 1975) (adopting Uniform Net Capital Rule).

11 17 CFR §15c3-1.

12 17 CFR §15c3-3.

13 The New York Stock Exchange contributed $75 million to protect customers of firms that failed. NYSE, Crisis in the Securities Industry, A Chronology 1967-1970, Prepared for the Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, House of Representatives, at 2. See also Finra, When Paper Paralyzed Wall Street, Remembering the 1960s Paperwork Crisis.

of market failure or investor loss that would warrant imposing such requirements on managers of private funds.

Unlike broker-dealers, investment advisers are prohibited by Rule 206(4)-2 under the Advisers Act (the "Custody Rule")[14] and other applicable rules from taking actual custody of client assets. If an investment adviser is deemed to have custody of client assets, the Custody Rule generally requires that such assets be held with a "qualified custodian" as defined in the Custody Rule (*e.g.,* a bank, broker-dealer, futures commission merchant or foreign equivalent). Accordingly, investment advisers generally do not have direct access to the assets of customers and, therefore, such customer assets simply do not face the same level or type of risk (*e.g.*, insolvency, fraud) as those assets directly held by broker-dealers or other types of institutions. Imposing requirements that were designed to address risks that are not relevant to investment advisers would be of minimal use for investor protection while potentially imposing significant burdens on the investment adviser community. Moreover, qualified custodians are themselves subject to extensive customer protection and net capital requirements mandated by the Commission, the Commodity Futures Trading Commission, the federal banking agencies and/or foreign financial regulators. Imposing comparable requirements on investment advisers would be duplicative and would not address the risks that those requirements were designed to mitigate.

Also unlike a broker-dealer or bank that is principally liable to its customers for the assets it holds on behalf of those customers, the circumstances under which clients would have enforceable claims against investment advisers are more limited in nature. Capital requirements intended to shield clients of an investment adviser from such risks are likely to be imprecise and would result in investment advisers holding capital against theoretical claims of uncertain frequency, probability and value. We do not believe, therefore, that capital requirements are likely to be an effective or efficient mechanism to address the policy considerations raised by the Commission in the Interpretation. Moreover, the costs of such a framework (including the costs of diverting such capital from more productive purposes and increasing costs that could limit investor options in choosing professional investment advice) would be disproportionate to the potential benefits to clients. Accordingly, and notwithstanding the importance of prudential regulation in certain contexts, given the burdens such regulations inflict upon those subject to them, the Associations believe that Commission should not propose net capital requirements unless it has identified a compelling policy interest in proposing such requirements to address a specific and identified risk.

This is particularly so with respect to rules, such as capital or similar requirements, that can create significant barriers to entry for investment advisers, which can limit investor choice in investment advisers or increase the costs of investment for clients that use investment advisers by significantly raising the costs across the industry. Specifically, if the Commission determines to implement a net capital requirement at a level that would require investment advisers to maintain a minimum amount of net capital for contingent liabilities, such a capital requirement, in addition to acting as a barrier to entry for new advisers, would likely cause existing investment advisers to exit the business and, for those firms that remain, increase adviser fees and costs to clients. All of these outcomes would limit investor choice to only those firms owned by persons or entities with the ability to leave significant assets in the business in the form of net capital and increase the cost of

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14 17 C.F.R. §206(4)-2(a).

investment advice provided to clients, even for those clients who deem that increased cost unnecessary.

As the Commission considers whether to propose capital or similar requirements, the Associations urge the Commission to consider the significant steps toward greater investor protection that have evolved through existing rules and industry practice. For example, investment advisers to private funds (including affiliates and control persons of the investment advisers) generally hold significant capital in such private funds, thereby further aligning their interests with those of the funds' investors. Also, in many cases, private funds retain third-party administrators to confirm or verify the existence, location and valuation of fund assets on an ongoing basis, and to provide reports directly to investors. In many cases, operative documents executed among investment advisers, their pooled investment vehicle clients, and the investors in such pooled investment vehicles require the delivery of audited financial statements to the investor and not just to the pooled investment vehicle. Similarly, sophisticated and institutional clients (including pooled investment vehicles) frequently negotiate for a requirement that the investment adviser deliver periodic account statements to the pooled investment vehicle's investors.

In light of the concerns with imposing capital or similar requirements, the Associations believe that further study into whether and how such rules would improve investor protections without creating undue costs or burdens is necessary before the Commission determines whether to move forward with new regulatory proposals. To the extent that further study demonstrates that risks to investors are not adequately addressed by existing law, regulation and commercial practice, the Associations would welcome further public dialogue regarding the specific issues of concern that rulemaking would attempt to address and how proposed rules would address those concerns. Further, before moving forward with new proposed requirements, the Associations also recommend that existing rules be reviewed in order to prevent duplicative requirements. For example, if a fidelity bonding requirement were to be proposed, the Associations believe certain aspects of the Custody Rule, such as the surprise audit requirements of Custody Rule, would no longer be necessary.[15]

With respect to the potential requirement for investment advisers to obtain annual audits of their own financial statements and to make such information available on Form ADV, the Associations do not believe that such requirement would be useful or practical. The financial statements of an investment adviser are largely irrelevant to the level of service that an investment adviser provides to its clients because investment advisers do not hold investor assets on their balance sheets, or generally incur financial liabilities to their clients. Accordingly, requiring audited financial statements for investment advisers would be of minimal benefit to current and potential clients, could potentially mislead clients into believing that the financial resources of investment advisers would protect clients against the risks associated with their investments, and would come at significant cost to the investment adviser. Moreover, many investment advisers (including those with substantial amounts of assets under management) are closely held by small groups of individuals (or, in some cases, a single individual). The Associations believe that requiring these firms to disclose financial information publicly would represent a significant infringement upon the privacy rights of these individual owners without any commensurate benefit to the public.

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15 *Id.*

Similarly, the Associations believe that the Interpretation does not establish a compelling policy rationale for implementing a fidelity bonding requirement for investment advisers. While the Associations understand the Commission's view that, because many investment advisers maintain minimal net capital in the business, there may not be enough assets in the firm to cover losses if the Commission or its staff identifies a fraud, we believe that further analysis of the costs associated with a fidelity bonding requirement (which may ultimately be passed to clients in the form of higher fees) is needed to demonstrate the benefits of such a requirement compared to existing market practices, particularly with respect to advisers to sophisticated clients.[16] In the context of investment advisers to sophisticated clients, we believe the decision as to whether an adviser should purchase a fidelity bond or other similar type of insurance product is best left to the adviser and its clients.

II. Federal Licensing and Continuing Education Requirements

In the Interpretation,[17] the Commission requests comment on whether there should be federal licensing and continuing education requirements for personnel of Commission-registered investment advisers. The Associations do not believe that it is necessary or appropriate for the Commission to adopt regulations implementing federal licensing and continuing education requirements for investment adviser representatives. When Congress enacted the National Securities Markets Improvement Act of 1996 ("NSMIA"), it made the decision to leave licensing and registration of investment adviser representatives to the states.[18] As a result of this act of deference, an existing system of state licensing and continuing education requirements has developed and is currently imposed upon investment adviser representatives. While not centrally administered by the Commission or a self regulatory organization,[19] this state registration regime has proved effective over time with each state establishing such requirements as deemed necessary to provide for investor protections in the applicable state. Absent a compelling policy reason, which we do not believe has been demonstrated by the Commission, the Associations do not believe that the Commission should propose requirements that would supersede or preempt state registration and continuing education requirements. Unless the Commission can provide a strong, overriding reason for federal regulation of the licensing requirements for investment adviser representatives, the determination and enforcement of such requirements should remain with the states, as intended by Congress.[20]

III. Provision of Account Statements

In the Interpretation,[21] the Commission requests comment regarding whether it should propose rules to require registered investment advisers to provide account statements, either directly or via the client's custodian, regardless of whether the adviser is deemed to have custody of client assets under the Custody Rule or the adviser is a sponsor (or a designee of a sponsor) of a managed

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16 Interpretation, *supra* note 3, at 21213-14.

17 *Id.* at 21211.

18 *See* National Securities Market Improvement Act of 1996, H.R. 3005, 194th Cong., 2d Sess. § 209 (1996).

19 We note, however, that FINRA administers certain testing requirements on behalf of the states.

20 *Id.*

21 Interpretation, *supra* note 3, at 21213.

account program relying on the safe harbor provided by Rule 3a-4 (the "Advisory Program Rule") under the Investment Company Act of 1940, as amended (the "1940 Act").[22]

Under the Custody Rule, investment advisers with custody (as defined in the Rule) are required to have a reasonable belief that clients receive account statements from the qualified custodian(s) holding client assets.[23] Similarly, in order for an advisory program sponsored by an investment adviser to qualify for the safe-harbor from registration as an investment company under the Advisory Program Rule, the investment adviser must provide each client with a statement, at least quarterly, containing a description of all activity in the client's account during the preceding 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.[24] While it is common for some investment advisers to provide customers with account statements, other than these specific requirements there is currently no express requirement under the federal securities laws for an investment adviser to deliver an account statement.

The Associations do not believe that it would be necessary or appropriate for the Commission to implement an account statement requirement for investment advisers beyond the exception-based circumstances that are part of the Custody Rule and the Advisory Program Rule. The reason that there is no requirement for an investment adviser to provide account statements other than in these exception-based circumstances is that investment advisers generally do not have custody of client assets. Rather, investment advisers typically provide advisory services with respect to assets that are held at other financial institutions (each a "Custodian"), each of which is required to provide to the clients account statements reflecting the deduction of fees and expenses related to the investment adviser. Accordingly, any requirement that an investment adviser also deliver an account statement would be duplicative and may create client confusion if, due to timing of generation or other factors, statements provided by the investment adviser differ from those provided by the Custodian. Even the account statement requirements of the Custody Rule and the Advisory Program Rule do not require that the investment adviser directly provide account statements. Rather, in the case of the Custody Rule, the investment adviser is required to use reasonable means to confirm that a "qualified custodian" with custody of the assets provides account statements, and in the case of the Advisory Program Rule, the investment adviser that is the sponsor of the program is required to either provide the statement or arrange for a custodian to provide the account statement.[25]

IV. Conclusion

If the Commission chooses to move forward with any of the additional rules, the Associations recommend that the Commission, at the same time, review existing rules that are in

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[22] 17 C.F.R. §270.3a-4.

[23] 17 C.F.R. §206(4)-2(a)(3).

[24] 17 C.F.R. §270.3a-4(a)(4).

[25] *See* 17 C.F.R. §270.3a-4(a)(4). We note that, under the Advisory Program Rule, the requirement is that the "sponsor or person designed by the sponsor" provide the account statement. In most cases, the custodian of the investment advisory program serves as such designee.

place to provide investor protections to avoid unnecessary duplication. The Associations thank the Commission for the opportunity to provide these comments on the possible additional rules set out in the Interpretation. Further, we welcome the opportunity to work with the Commission and provide any additional information that may be required. Please do not hesitate to contact Benjamin Allensworth, Matthew Newell, or Stuart Kaswell of MFA at [redacted], or Jiří Król or Jennifer Wood of AIMA at [redacted] should you have any questions.

Respectfully submitted,

/s/Stuart J. Kaswell	/s/ Jiří Król
Stuart J. Kaswell Executive Vice President & Managing Director, General Counsel Managed Funds Association	Jiří Król Deputy CEO, Global Head of Government Affairs Alternative Investment Management Association