Remarks Of

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Adjust Investment Adviser Reform

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Grassroots Task Force
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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

With the explosive growth in the investment adviser industry, triggered by a growing trend of investors trusting their money to professional or institutional money managers, greater attention is being focused on the investment adviser regulatory framework. Issues arise concerning whether there is enough regulation, oversight, and customer protection. Even fundamental questions such as who is an "investment adviser" continue to surface. Legislation has been introduced in each of the past three years, media articles have been written, and the Securities and Exchange Commission (the "Commission"), with limited resources, continues to police aggressively this burgeoning industry. Yet, nothing in the way of changes to the regulatory framework has occurred to date. It is time to re-examine the industry with a view towards alternative ways to improve the system.

II. Investment Adviser Profile

The investment adviser industry appears to be dominated, in terms of number, by small entities. Of the approximately 18,000 registered investment advisers, more than half have no assets under management. Approximately half appear to have only one employee performing advisory functions. Only about five percent of registered investment advisers have more than 10 employees. Almost three-quarters of all registered investment advisers have fewer than 15 clients. Less than one-third manage assets greater than $1 million.

On the other hand, the industry has some very large members. The approximately 6,000 registered investment advisers that manage $1 million or more manage 99 percent of all assets under management. About five percent of registered investment advisers each manage more than $500 million. These advisers account for over 70 percent of all assets under management. Over 200 advisers each have more than $5 billion under management.

III. Areas of Concern

Although no final legislative action has been taken, concerns persist. In 1988, NASAA, the national organization of state securities regulators, produced a report documenting 79 instances where financial planners caused 22,000 investors to lose $400 million. The General Accounting Office estimated in a July 1990 report that investment adviser fraud costs investors between $90 and $200 million annually. Since October 1991, the Commission has brought almost 40 fraud actions against investment advisers. This includes the well-publicized case against Steven D. Wymer and his Institutional Treasury Management Inc., managing $1.2 billion in assets, in which investors lost more than $100 million.

The flow of fraud cases continues amid an explosive growth in the investment adviser industry. Between 1981 and 1991, the number of registered investment advisers grew from 4,580 to 17,500. Assets under their management grew from $440 billion to more than $5.3 trillion, greater than the GNP of many countries.

Against this backdrop of growth, the number of Commission investment adviser examiners have grown from 36 to 46. That is approximately one examiner for every 380 investment advisers. This means that the staff inspects an investment adviser once every 30 years on average, although large advisers are inspected more frequently and small advisers rarely, if ever. These numbers, of course, do not take into account the unknown quantity of unregistered investment advisers that should be registered with the Commission.

It has become obvious that there is a growing gap between the number of advisers registering and the Commission personnel attempting to oversee the industry. To address this concern in a cost-effective manner, the Commission arguably needs a combination of significant additional funding to enlarge its inspection staff and a more efficient way to police the industry. The Commission is pursuing the first prong through legislation addressing funding and regulatory gaps, but I would submit that the Commission is not pursuing the second prong with the same vigor. That is unfortunate since I argue that both are necessary for any reform to be cost-effective or even just effective for that matter.

IV. Legislation

First, I will discuss the current effort to achieve legislative investment adviser reform. On January 26, Congressman Rick Boucher of Virginia introduced H.R. 578, the "Investment Adviser Regulatory Enhancement and Disclosure Act of 1993." Congressman Boucher has been introducing investment adviser legislation since H.R. 4441 back in March of 1990. This year's bill is similar to the same bill that passed the House in the waning days of last year's legislative session. That bill died in conference with a Senate bill that was considerably more limited in scope. It may be helpful at this juncture to describe quickly the bills passed by the House and Senate last year.

The Senate passed S. 2266, the "Investment Adviser Oversight Act of 1992" on August 12, 1992. This bill would have authorized the Commission to collect fees from registered investment advisers for the purpose of funding increased inspections of industry members. In addition, S. 2266 would have: 1) permitted the Commission to establish a central repository for fees, records, and reports with a view towards creating a "one-stop" registry to fulfill both state and federal registration requirements; 2) permitted the Commission, in certain circumstances, to require investment advisers to obtain fidelity bonds; and 3) removed a statutory restriction on affiliates of investment advisers from executing the adviser's trading orders on a national securities exchange.

On September 22, the House responded by passing H.R. 5726, the "Investment Adviser Regulatory Enhancement and Disclosure Act of 1992." This legislation was more comprehensive than the Senate passed bill; and while I acknowledge that both bills would improve the status quo, I prefer the more comprehensive House approach. H.R. 5726 also provided authority to collect fees to cover the costs of registration, supervision, and regulation of investment advisers. Likewise, there were provisions for a centralized registry and a fidelity bond requirement.

H.R. 5726 went on to permit the Commission's designation of an investment adviser self-regulatory organization for inspections only and to permit the Commission to deny registration to persons convicted of any felony in the last ten years.

Apart from giving the Commission some expanded authority, the House passed bill would have imposed new requirements for both the Commission and investment advisers as well. H.R. 5726 would have required the Commission to establish an internal schedule for inspections of investment advisers. The anti-fraud provisions of the Act would have been extended to apply to persons associated with an investment adviser and would have included a prohibition against guaranteeing specific results to clients. Along with the anti-fraud amendments, H.R. 5726 contained an express suitability provision that required advisers to make reasonable inquiries and determinations as to the suitability of the investment to the particular client's financial circumstances and objectives. Advisers would have been required to keep all client financial information confidential, unless adequate notice was given to the client, or unless the law provided otherwise.

The decision to impose a suitability provision is controversial but warranted in my opinion. While the national securities exchanges and the National Association of Securities Dealers ("NASD") impose express suitability requirements, there is no self-regulatory organization to establish standards for investment advisers; and all investment advisers are not presently covered by the rules of the national securities exchanges or the NASD. Some argue that the antifraud provisions of the Advisers Act contain an implied suitability requirement, but a creative mind and an expansive reading of the Advisers Act is necessary to reach that conclusion.

I do believe that an express suitability provision is needed. Investors using advisers are the least likely to be sophisticated and therefore are in the greatest need of protection from unsuitable recommendations.

H.R. 5726 would have provided further investor protection by requiring greater disclosure by the investment adviser. Specifically, clients of investment advisers would have received periodic statements containing greater disclosure of hidden commissions and fees.

Finally, the House inserted a federal-state cooperation clause to encourage greater cooperation and coordination between the Commission and state securities officials. The purpose of this cooperation clause was to achieve a more effective and uniform regulatory program. In particular, the House sought an information exchange between regulators and uniform inspection standards, as well as uniform exemptions for small investment advisers.

This year's House bill, H.R. 578, has a few changes. Gone are some of the dictates for the Commission's inspection schedule and the federal-state cooperation clause. It remains to be seen whether the House will be able to harmonize their bill with the narrower one that is likely to come out of the Senate.

The gist of all the legislative proposals is that the Commission cannot perform the necessary oversight of investment advisers without greater resources to fund more examinations of individual advisers. While I agree with that premise, I am of the view that present Commission plans for the use of those additional resources is not cost-effective. Congress is proposing to permit the Commission to levy annual fees between $300 and $7000, depending upon the size of assets under management, in order to raise approximately $16 million to fund an inspection cycle. The proposed cycle would include an inspection of each large adviser (having greater than $1 billion under management) every three years and all other advisers every 5 1/2 years. I have grave doubts concerning the Commission's ability to meet the ambitious inspection schedule proposed for the other than large advisers unless that universe is reduced.

V. Federal-State Cooperation

There is no doubt that greater resources will enhance the Commission's oversight of investment advisers and may be necessary. However, the greater resources must be used effectively, or the money expended to acquire them represents squandered federal dollars, which unfortunately is an all too familiar occurrence. To adequately and effectively surveil the investment adviser industry, in my judgment, the Commission should design a more efficient method of policing the industry. It could do so with the assistance of the states.

For the Commission to examine all the currently registered advisers on a regular basis would require a massive staff and would require great resource expenditure for federal oversight of small advisers with little or no investor money under management. Further, any representation as to the ability of the Commission to examine adequately the small advisers on a frequent basis must be taken with a grain of salt. This problem will intensify if the growth of small advisers continues to explode. Some suggest that the Commission inspection schedule for other than large advisers will end up being in actual application closer to once every 10 years rather than once every 5 1/2 years. I submit that a 10 year inspection cycle for small advisers is a waste of time and money as a policing mechanism. Even if the proposed schedule is met, it is arguable as to whether an inspection interval of almost six years for small advisers would provide effective protection for investors.

The statistics concerning the adviser industry suggest that a federal oversight program focusing on medium and large investment advisers would obviate the need to police the majority of advisers, while at the same time preserve the oversight of the vast majority of the assets and client accounts under management. The small advisers, having little or no national relevance, could better be overseen by state regulators who may be more cognizant of the activities of local advisers.

This is not the only area where state and federal jurisdiction concerning securities law overlap. Business persons raising capital or providing securities-related services are often frustrated in that they are subject to redundant regulation. These regulatory costs are especially burdensome on small entities. In responding to the needs of the small business issuers, the Commission recently adopted a set of rules that included a blanket exemption for all offerings under $1 million. [1] The rules also included innovative and streamlined disclosure requirements for other small offerings exceeding $1 million, but these advances have been frustrated due to a lack of Commission coordination with the states.

A similar $1 million threshold for investment advisers in the form of a blanket exemption from registration makes more sense than the current legislative approach of requiring

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1 Securities Act Release No. 6949 (July 30, 1992).

federal oversight of all registered investment advisers. Such a program would subject the largest 6000 investment advisers to federal oversight, while the remaining 12,000 advisers would be divided among the various states. The Commission would have the resources to closely monitor the significant advisers and thereby protect 99% of all assets under management. It would be these advisers that are most likely to have an interstate business and national reputation. Further, the Commission would be in a better position to enforce vigorously the investment adviser registration requirements. Such a program would also be cost-effective and, more importantly, achievable. I do not believe the current proposed inspection program for other than large advisers is realistically achievable.

Before proceeding further, I should note that the Advisers Act currently has some exemptions for small advisers. Unfortunately, they have little utility. Section 203(b) of the Advisers Act provides two potential exemptions from registration as an investment adviser for small entities.[2] First, there is an intrastate exemption for advisers whose clients all reside in one state. The problem with this exemption is that it further prohibits giving advice about securities listed on a national securities exchange. Obviously, the exemption is of little use. The same is true for the second exemption, which is for advisers with less than 15 clients. The limiting factor is that the exemption is conditioned also upon the entity not "holding itself out" to the public as an adviser. This would include the use of business cards and advertisements. Therefore, only a person with fewer than 15 clients that is content to seek no more clients would be eligible. This exemption is of even less use than the first one.

VI. A Proposed Solution

Thus, a statutory exemption, or further rulemaking authority, would be needed to implement a workable exemption for small local advisers who are now proposed to be caught in the federal "web" of regulation. Since Congress

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2 There is also an exemption for advisers that serve only insurance companies. 15 U.S.C. 80b-3(b)(2).

is now focused on the issue, it may be a good time to seek such authority.

In exempting small advisers, there should be a condition that the adviser has registered with each of the states in which it does business. Further, such a small adviser would no longer receive the Commission's registration certificate which has been utilized in the past as a sort of "good housekeeping" seal of approval. Therefore, in no case should an adviser be free from regulatory oversight. In addition, I believe it is important for the Commission to retain jurisdiction to bring anti-fraud cases against small advisers. This was the approach utilized in the small business issuer $1 million exemption from the Securities Act. To facilitate the detection of fraud, it also may be important for the Commission to retain the ability to conduct "cause" examinations of exempted small advisers.

The net effect of this program would be to focus federal attention upon national advisers and state attention upon local advisers. The Commission, with greater resources from increased fees, would be able to conduct frequent and comprehensive inspections of these national entities, which account for virtually all the assets under management. Further, the Commission would be in a better position to more effectively enforce the adviser registration requirements. In addition, the staff should have sufficient resources to conduct "cause" inspections on an as-needed basis, where customer complaints or state regulators suggest evidence of fraud.

To suggest that the passage of the current House bill, H.R. 578, will prevent the reoccurrence of another Steven Wymer type fraud may be misleading. It is difficult to understand how the Wymer case can be used as a justification for the passage of H.R. 578. If anything, the Wymer case stands for the proposition that the Commission's current inspection schedule for large advisers was flawed. Wymer was a larger adviser and arguably already subject to Commission inspection, yet his fraud was uncovered not as the result of a routine inspection but as the result of a tip which triggered a cause examination. I suppose that the Wymer case can be used as a justification for additional Commission resources to inspect large advisers. The program I have advocated would accomplish that. H.R. 578, in illogical fashion, uses the Wymer case as the justification for providing the Commission with additional resources to inspect small advisers.

There is no doubt that investment adviser oversight would be improved by H.R. 578; but to monitor effectively 18,000 or more investment advisers, many of which are small and disappear before an effective inspection regimen can be instituted, appears to me to be spreading the Commission, even with additional resources, too thin to be fruitful. The Commission will probably not meet any proposed inspection schedule for small advisers anyway. Instead, greater qualitative attention to a smaller universe of advisers that have the greatest impact upon investors would appear to permit the staff to conduct examinations with such regularity that the Steven Wymer type fraud would not go unnoticed. As adjusted, H.R. 578 would then contain the approach necessary to achieve investment adviser reform in a cost-effective, realistically achievable manner.