Remarks Of

Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

# Investment Adviser Reform

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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.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

## Investment Adviser Reform

### I. Introduction

The importance of regulatory oversight of investment advisers was recently highlighted with the discovery of what could be one of the more important securities fraud cases in many years. An inspection of Institutional Treasury Management ("ITM"), a registered investment adviser, by the staff of the Securities and Exchange Commission (the "Commission") led to the indictment of Stephen D. Wymer on thirty counts of securities fraud, mail fraud, money laundering, making false statements to Commission staff, and obstruction of justice.[1] This fraud came to light after the Commission's Los Angeles Regional Office ("LARO") received a complaint from an employee of the State of Iowa regarding possible improper option trading by Wymer for the account of an Iowa community. A subsequent cause examination by the LARO resulted in the discovery of discrepancies between the records of the custodian and those of Wymer.

Wymer has consented, without admitting or denying the Commission's allegations, to be permanently enjoined from further

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1 See SEC News Digest, Criminal Proceedings (Jan. 7, 1992).

violations of the federal securities laws charged in the Commission's complaint. While the investigation continues to proceed with respect to the issues of disgorgement and penalties, a picture of the fraud has emerged. Wymer managed approximately $1.2 billion of assets of municipalities and other government entities from some thirteen states. Most of the money lost appears to be from the account of Iowa Trust, which pooled the assets of scores of the state's small town, county and other government pension plans. Wymer sold his advisory services mainly to treasurers of these small communities by promising high, risk free returns in exchange for fees ranging up to 30 percent of gains. When the investments failed to achieve these gains, he began engaging in fictitious trades and mailing false confirmations and monthly statements to clients showing considerable gains from which he deducted his fees. To fund the fictitious gains, client withdrawals, and his fees, Wymer moved assets in a Ponzi-like scheme from accounts of other clients. The receiver appointed to supervise the assets of ITM estimates that losses to clients' accounts may amount to over $100 million.

The Wymer case has brought national attention to the Commission's investment adviser regulatory program and provides an opportunity for the Commission to acquire, among other things, the resources necessary to conduct an adequate investment adviser inspection program.

## II. Present Inadequate Commission Investment Adviser Inspection Program

Concerns about the inadequacies of the Commission's investment adviser oversight program are not new. In June 1990, the General Accounting Office ("GAO") issued a report on the Commission's investment adviser regulatory program. The GAO's conclusions were troubling:[2]

> SEC's oversight of investment advisers provides investors little assurance that the information they receive from investment advisers is accurate or that advisers operate in accordance with the requirements of the Advisers Act and SEC regulations. . . If the oversight program is not improved, the Advisers Act may be doing more harm than good by giving investors the illusion that SEC-

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[2] Investment Advisers, Report of the United States General Accounting Office to Congressional Requesters (June 1990), GAO/GGD - 90 - 83.

registered advisers have a "seal of approval."

Since the GAO report was issued a year and a half ago, the number of investment advisers has increased twenty-five percent to approximately 17,500 Commission registered investment advisers managing approximately $5.4 trillion in investment company and non-investment company assets. In 1981 by contrast, there were 4,580 investment advisers registered with the Commission. Thus, some ten years later, there are approximately 17,000 more advisers. During this same ten year period, however, the number of Commission investment adviser examiners has increased from thirty-six to forty-six. Of the 17,500 registered advisers approximately 500 have assets in excess of $1 billion and are considered "large" by current Commission inspection standards.

During fiscal year 1991, the Commission's staff inspected 574 investment advisers managing $1.6 trillion in assets (approximately 30% of industry assets), including 25 in the Ohio Valley.[3] Last year, at the

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[3]

| | IL | IN | KY | OH | TN |
|---|---|---|---|---|---|
| No. of advisers registered | 823 | 248 | 87 | 766 | 142 |
| No. of advisers examined in FY 91 | 16 | 0 | 2 | 3 | 4 |
| No. of advisers | | | | | |

(continued...)

direction of Commission Chairman Richard Breeden, Commission investment company and investment adviser inspection efforts were refocused on the 100 largest investment company complexes, on money market fund complexes, and on investment advisers with $1 billion or more in assets. This approach enabled the Commission, with its few available resources, to reach a larger percentage of the investment industry's assets. Unfortunately, this approach also means that fewer advisers are inspected.

While the Commission also conducts "for cause" inspections, under the present Commission investment adviser inspection program, few, if any, of the 17,000 registered investment advisers with less than $1 billion under management will ever see a Commission examiner. In the absence of additional resources, there cannot be any meaningful increase in the number of Commission inspections without significantly sacrificing the quality of these inspections. I believe that it is clear from these numbers that the current Commission investment adviser inspection program is woefully inadequate. This afternoon I wish to discuss some of the

[3](...continued)

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|---|---|---|---|---|---|
| managing $1 bil or more | 22 | 4 | 3 | 14 | 2 |

alternatives available to improving oversight of the investment advisory industry.

## III. Proposals to Resolve the Resource Shortage

### A. Legislative Proposal

The legislative history of the Investment Advisers Act of 1940 (the "Act" or the "Advisers Act") indicates that the original purpose of the Act was to safeguard the public and to ensure certain minimum standards for the benefit of the advisory industry.[4] Only by reestablishing a vigorous adviser inspection program based on a reasonable inspection cycle can these purposes be achieved. In order to provide the Commission with the resources to implement an adequate adviser inspection program, the Division of Investment Management (the "Division"), at the direction of Chairman Breeden, is in the process of drafting an adviser legislative proposal to recommend to the Commission for submission to the Congress that would, among other things, increase investment adviser registration fees and require these fees to be paid on an annual basis.

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[4] See H.R. Rep. No. 2639, 76th Con., 3d Sess. 28 (1940).

Currently advisers pay a one-time registration fee of $150. This fee has not changed since 1972 and in no way correlates to the cost of Commission adviser regulation. The proposed legislation would probably require advisers to pay, upon application for registration and annually thereafter, a fee based upon assets under management. Without the ability to keep the fees collected, however, fee increase proposals are meaningless. Last year for the first time, the Commission's budget was partially self-funded from filing fee revenues collected. The Commission collected fees of $259 million in fiscal year 1991 - $70 million more than its allocated budget of $189 million. Of that, the Commission was authorized by Congress to retain $36.9 million. I anticipate that any fee proposal that the Commission submits to Congress will request that any increased fees be allocated specifically to the Commission.

Because the primary purpose of the legislation would be to enable the Commission to fund an enhanced adviser inspection program, the amount of revenue required would depend largely upon the desired average frequency of inspections. It is my understanding that an annual fee in the range of $800 to $6,000, tiered depending upon the assets under

management, would permit the Commission to inspect large advisers (assets over $1 billion) every three years and other advisers about every five years. That appears to me to be an appropriate inspection schedule. Obviously any fee range would need to be indexed for inflation.

In addition to increased fees to enhance the Commission adviser inspection program, the Division is also apparently considering including in this legislative package: (1) the creation of an express "suitability" requirement for advisers, (2) the creation of a statutory basis for the Commission to develop with the states "one stop filing" for advisers, and (3) the creation of a statutory basis to enable the Commission to require advisers to obtain fidelity bonds. Although not creating a new obligation, an express suitability requirement would make clear that an adviser, as a fiduciary, has a duty to give advice that is suitable in light of the client's financial situation, investment experience, and investment objectives. Further, a congressional delegation of authority to the Commission: (1) to designate an organization, such as the NASD, its agent for the receipt of adviser filings, and (2) to permit that agent to charge a fee for the reasonable costs associated with its services, would greatly facilitate the

implementation of a "one stop filing" mechanism for federal and state adviser filings. It will be interesting to see both what legislative provisions are recommended in this area by the Commission and what legislation ultimately receives congressional approval.

B. Other Alternatives

(1.) SROs

There are other alternatives available, in addition to the above described legislative proposal, which may be considered by the Commission as an integral part of an investment adviser reform package. For instance, in 1989, legislation was introduced in Congress at the behest of the Commission which would have authorized the Commission to register one or more national investment adviser self-regulatory organizations ("SROs") subject to Commission oversight. Approved SROs would establish qualification and business practice standards, perform inspections, and enforce compliance with the law. Such self-regulation systems have been authorized in the past to regulate the activities of broker-dealers, municipal securities industry professionals, and futures industry professionals. This approach would generally require mandatory

SRO registration for all Commission registered investment advisers.

It is my understanding that the Commission's 1989 SRO legislative proposal was not received warmly. Most commenters indicated that they objected to subjecting advisers to another layer of regulation and preferred instead direct Commission regulation. I probably agree with these objectors, and, at this time, I would not be inclined to resurrect this SRO proposal.

(2.) Increase State Involvement

Another alternative would be to involve the states to a greater degree in investment adviser regulation. In 1988, the Commission proposed amendments to its rules under the Advisers Act that would have exempted from Commission registration and most Commission regulation, certain "intrastate" and "small" advisers.[5] The intrastate exemption would have exemped advisers who operate solely in one state. To qualify for the proposed intrastate exemption, an adviser would have to be registered in that state and could have no more than fifty clients with total aggregate assets under management of $10 million.

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[5] Investment Advisers Act Rel. No. 1140 (Sept. 16, 1988) [53 FR 36997 (September 23, 1988)].

The proposed small adviser exemption would have exempted advisers with no more than twenty-five clients with total aggregate assets under management of $1 million. This proposed exemption would have required small advisers to register in each state in which they do business. Under the 1988 proposal, exempt intrastate and small advisers would have continued to be subject to the Act's antifraud provisions.

Obviously, states face budget problems similar to that of the federal government. However, there is no reason why state securities regulators could not attempt to develop, on a state level, a flow-through fee concept similar to that being considered by the Commission to enhance its investment adviser inspection program. This approach would enable the applicable state authorities to acquire the resources sufficient to effectively regulate exempt intrastate and small advisers.

An objection historically to the intrastate and small adviser approach has been that states would then subject all advisers, exempt or not, to direct, heavy state regulation, thereby unnecessarily increasing the burden on large advisers and undermining the goal of uniform regulation. I am confident that consultations between the North American Securities

Administrators Association ("NASAA"), the Commission, and the investment advisory industry could avoid such a result. The exempt intrastate and small adviser approach, with its federal-state partnership implications, appears to be attractive from a cost efficiency standpoint and should, in my judgment, be given serious consideration.

(3.) Private Rights of Action

Presently investors do not have the right to sue investment advisers privately under the antifraud provisions of the Advisers Act. The Commission historically has supported efforts to establish a private right of action to permit investors to supplement the Commission's investment adviser enforcement efforts. In fact, in testimony before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce on July 18, 1990, Commissioner Mary Schapiro stated that "[t]he Commission supports the creation of private rights of action under Sections 206(1) and (2) of the Advisers Act."[6]

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[6] Testimony of Mary L. Schapiro, Commissioner, U.S. Securities and Exchange Commission, concerning H.R. 4441, the "Investment Advisors Disclosure and Enforcement Act of 1990", before the Subcommittee on Telecommunications and Finance of the (continued...)

Further in 1990, Congressman Rick Boucher of Virginia, who has been a leader in calling for investment adviser reform, introduced legislation[7] that, among other things, would create express private rights of action against advisers who commit substantive fraud or fail to disclose: (1) material conflicts of interest, (2) an estimate of the cost of the adviser's services, or (3) any non-cash compensation to be earned. I believe that Congress should consider amending the Advisers Act to provide for an appropriate express private right of action. However, while private actions can supplement the Commission's enforcement program, they cannot substitute for a vigorous and well-staffed Commission inspection and enforcement program. Moreover, unlike Congressman Boucher, I am not prepared at this time to support an extension of the Commission's investment adviser regulatory program to cover financial planners.

[6](...continued)
Committee on Energy and Commerce, United States House of Representatives, July 18, 1990, at 14.

[7] H.R. 4441, 101st Cong., 2d Sess. (1990).

(4.) <u>Improve Disclosure Requirements</u>

As an adjunct to solving the investment adviser oversight resource problem, the Commission could also make efforts to improve the investment adviser disclosure provided to investors. To the extent that investors are better informed, the Commission may be able to compensate somewhat for reduced oversight efforts. For example, many investment advisers earn money by collecting commissions on the investment products that they sell to their clients. Requiring improved disclosure regarding adviser fees may result in fewer instances of fee abuses.

Currently, advisers are required to provide investors with a standardized disclosure document setting forth certain material information. It is my understanding that the Division is considering undertaking efforts to expand the scope and usefulness of this document. One possibility would be to require investment advisers to disclose the percentage of compensation that they derive from a flat fee, a sales commission, and other types of charges.

IV. Financial Advisors

On a matter unrelated to the subject of investment adviser reform but relevant to the subject of investment advisers, it has come to my attention that late last year the Division, through a no-action letter, determined that a financial advisory firm that assists states and municipalities with new bond issues need not register as an investment adviser under the Act.[8] It is my understanding that this firm, for a flat negotiated fee, would provide a number of financial advisory services, including the after-sale comparison of market information and, if requested by the issuer, the making of recommendations about the investment of temporarily idle proceeds of an issuer pending their project use. The growth in the municipal bond industry of financial advisors who are apparently unregulated as being neither a broker-dealer nor an investment adviser, and who are also apparently not subject to professional standards of practice as are attorneys or accountants, has become quite troubling to me. While the Division's determination is

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[8] See letter from Linda A. Schneider, Attorney, Office of the Chief Counsel, Division of Investment Management, to Eneida Rosa, Esq., Brown & Wood (counsel for the Knight Group) (pub. avail. November 13, 1991).

consistent with an earlier no-action letter, I would urge the Division to reconsider this position.[9] It appears to me that the aforementioned financial advisory services to be provided by the firm fall squarely within the definition of "investment adviser" as set forth in the Advisers Act. Thus, I am inclined to believe that the firm should be required to register as an investment adviser.

## V. Conclusion

Due to the increasing number and complexity of financial products, the importance of the investment advisory industry continues to grow. Where advisers once were only a luxury of the wealthy, advisory services increasingly are being provided to a greater percentage of the population. For example, it is my understanding that one in four U.S. households now invests in mutual funds managed by an investment adviser. Given the increasing importance of this industry, the current Commission investment adviser regulatory program is inadequate for today's needs.

The perceptions created by the Wymer case and related articles and reports, on the one hand, may make some investors hesitant to engage

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[9] See Bruce H. Gemmel (pub. avail. July 14, 1976); Dominion Resources (pub. avail. August 22, 1985).

**advisers and, on the other hand, may encourage unscrupulous members of the investment advisory industry to take advantage of their clients. In conclusion, in my judgment, it is incumbent upon the Commission to embark on a course of action that will quickly result in vigorous investment adviser reform designed to maintain investor confidence in this important and growing segment of our securities industry.**