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News Release

Address to

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Conference on Current Issues in the Regulation
of Investment Advisers

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TO REGULATE OR NOT TO REGULATE:
CURRENT ISSUES CONCERNING INVESTMENT ADVISERS

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

CURRENT ISSUES IN THE FEDERAL REGULATION OF INVESTMENT ADVISERS

I am very pleased to have the opportunity to address this gathering today and would like to thank the Investment Company Institute for inviting me to speak. The first time I spoke in public on issues concerning investment advisers and investment companies was in July 1984 when I had been a Commissioner for only a few weeks. Kathie McGrath, Director of the Division of Investment Management, and Mary Podesta, our chief expert on investment advisers matters, performed major brain surgery in order to familiarize me with the arcane issues of your industry in just a few hours. But the ever-cautious Mrs. McGrath stayed right by my side while I spoke to ensure no slip-ups. Now, here I stand alone a scant twenty months later -- certainly no expert on the intricacies of the 1940 Act and the Advisers Act but brimming with thoughts and opinions about how your industry has, does and should operate. Today I intend to share a few of those overflowing thoughts and opinions with you as they relate to the issue "to regulate or not to regulate?" That is a question we at the SEC frequently ask ourselves these days.

Outsiders also often ask whether I or the agency is in favor of increased regulation or deregulation. The answer to that question -- at least in my case -- is "That depends!" It depends on the issue, the timing, and the circumstances. I have observed with interest that the same response is frequently given by those we regulate. Such a response from a regulated entity which one would think would always applaud the lifting of regulatory burdens or restrictions underscores the complexity of the relationship between government and private industry.

The fact is that all government regulations create some winners and some losers. Oftentimes, persons who are not subject to government regulation come to believe that regulation would be desirable and would improve their business opportunities. Moreover, occasionally, regulated individuals and businesses find certain regulatory requirements to be actually beneficial to them. Thus, when the regulators offer to do away with those requirements in the name of increasing competition or otherwise benefiting the public, their efforts are not infrequently resisted by the regulatees.

There are two recent developments in particular, which, I think, illustrate the fact that you cannot count on regulated persons to opt invariably for no or fewer regulatory restraints on their conduct. My first example relates to the Commission's recent decision to adopt Rule 205-3, a rule which permits investment advisers to enter into advisory agreements with their clients under which the adviser's fees can be based in whole or in part on the adviser's performance. As you undoubtedly know, this decision by the Commission was nothing short of a reversal of its historical position on performance-based fees for investment advisers.

When the Investment Advisers Act was adopted in 1940, the Act contained a prohibition against advisory contracts that provided for performance fees, except for contracts between investment advisers and registered investment companies. 1/ The legislative history of the Advisers Act contains very little explanation of the reasons behind this prohibition on performance fees. The Senate report does, however, characterize performance fees as "heads I win, tails you lose" propositions which could, it feared, cause an adviser to speculate unnecessarily with his client's assets. 2/

When Congress amended the Investment Company and Investment Advisers Acts in 1970, it made two changes to the Advisers Act that are relevant to our discussion. First, it extended the prohibition against performance fees to contracts between advisers and investment companies. However, since a rule would not be a rule without an exception, Congress dutifully provided one in this case. The exception is that performance fees could be charged on contracts with investment companies or for accounts under management with at least $1 million in assets, if the fee is a "fulcrum fee." A fulcrum fee increases or decreases proportionately with investment performance as measured against a securities index. 3/

1/ Investment Advisers Act of 1940, § 205, 54 Stat. 847 (1940) (current version at 15 U.S.C. 80b-5(1)).

2/ S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940).

3/ Investment Advisers Act of 1940, as amended, § 205, 15 U.S.C. 80b-5.

The second change made in 1970 was the addition of a new section to the Act, Section 206A. This provision permits the Commission to make rules exempting persons or transactions from any provision of the Act if "such exemption is necessary or appropriate in the public interest and consistent with protection of investors and the purposes fairly intended by the policy and provisions of" the Act. 4/ The legislative history of this new provision indicates that Congress specifically contemplated that the Commission would use its authority under the section to exempt persons from the ban on performance fees where appropriate. 5/

Over the years, the Commission has granted a number of individual applications by investment advisers wishing to charge performance fees. In light of increased applications and a changed environment, the Commission in June 1983 proposed a general exemptive rule -- proposed Rule 205-3 6/ -- that would have permitted advisers to charge performance fees if two conditions were met. First, an investment adviser would have to have a reasonable belief that a client, either individually or together with its representatives, was "financially sophisticated,"

4/ Id., § 206A, 15 U.S.C. 80b-6a.

5/ H.R. Rep. No. 1382, 91st Cong., 2d Sess. 42 (1970).

6/ Investment Advisers Act Release No. 865, 28 SEC Docket 187 (June 10, 1983).

a rather elusive criteria, I admit. Second, the client would have been required to commit at least $150,000 to the adviser's management.

Public comments on the Commission's proposed rule were decidedly mixed. Although many commentators supported the rule, others, including the Investment Counsel Association of America, opposed a performance fee rule in any form. In its comments, the association argued that performance fees represented an undue risk to clients' assets and could permit unscrupulous advisers to take advantage of their clients. Others, including the Investment Company Institute and the Securities Industry Association, opposed adoption of the rule unless it was substantially modified. In particular, the ICI and the SIA believed that the $150,000 minimum account size was too small. Due to the lack of consensus among commentators <u>and</u> members of the Commission, the Commission withdrew the proposed rule in May 1984. 7/

Undaunted, however, the Commission proposed a new version of Rule 205-3 in March 1985 8/ and adopted it in November 1985 9/ with certain revisions. The rule as adopted permits an investment

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7/ Investment Advisers Act Release No. 911, 30 SEC Docket 685 (May 2, 1984).

8/ Investment Advisers Act Release No. 961, 32 SEC Docket 1321 (March 15, 1985).

9/ Investment Advisers Act Release No. 996, 34 SEC Docket 913 (Nov. 14, 1985).

adviser to enter into an advisory contract that provides for compensation to the adviser to be based wholly or in part upon a share of the client's capital gains or capital appreciation if four conditions are met. First, the client either must have at least $500,000 under the management of the adviser or must be a person whom the adviser reasonably believes has an net worth in excess of $1 million. Second, the compensation paid to the adviser must be based on a formula which includes capital losses as well as capital gains, and the formula must be applied to a period of least one year. Third, there must be prior disclosure to the client of all material information concerning the advisory arrangement and the method by which investment performance will be measured. Finally, an investment adviser must reasonably believe that the contract represents an arm's length arrangement between the parties and that the client or its representative understands the proposed method of compensation and its risks.

I understand that the provisions of this rule will be discussed more fully by various panels of this conference, so I will not attempt to examine those provisions in detail or explore how the rule might apply to specific situations. I shall leave that to those with more expertise. However, I would like to make two comments.

First, Rule 205-3 is permissive, not mandatory, and it may well be that its adoption will have no significant impact on the way you as advisers run your businesses. On the other hand, there may be many of you who do have sophisticated clients with net worths of $1 million plus, and one of those clients may wish to negotiate a performance fee arrangement. Therefore, you may wish to know of a few significant limitations to the Rule's application. First, a number of states continue to have laws or rules which prohibit the use of performance-based fees. Thus, notwithstanding a liberalized rule at the national level, local laws may preclude you from charging performance fees. Furthermore, while the SEC has said you may charge performance fees, the Department of Labor, which has jurisdiction over pension fund managers under ERISA, prohibits ERISA plans from paying such fees. Finally, if performance fees prove to be as beneficial in reality as it was suggested they would be in theory, perhaps those of you with relatively few clients having a net worth in excess of a $1 million or maintaining accounts that exceed $500,000 will begin to urge further liberalization of Rule 203-5. Therefore, I do not see the Commission's adoption of this rule as being the last word on this subject. The Commission, in light of its experience with current Rule 205-3, may consider it appropriate at some point in the future to lower or raise the minimum net worth or account size requirements of the rule. What other regulators will do remains to be seen.

My second point relates back to my earlier observation concerning one's inability to predict the reaction of the regulated to liberalizing moves by regulators. The Commission's experience with the 1983 and 1985 performance fee proposals supports my thesis that regulated persons do not always welcome every government attempt to relax regulatory restrictions. The industry reactions to performance fee proposals were a far cry from the hosannas and hallelujahs one might have expected.

A cynic might suggest that some opposition may have been prompted by a desire to limit competition in the industry. I would prefer to believe, however, that most of the opposition was motivated primarily by the legitimate concern of reputable businessmen -- and businesswomen -- that a relaxation of regulatory restrictions would permit unscrupulous operators to harm unsuspecting investors. Individual abuses in turn may tarnish the reputation of the entire industry. I share those concerns, but in voting for the adoption of Rule 205-3, I concluded that the times had changed and it was time to reflect those changes in our rules.

The investment advisory industry has grown enormously over the past few years with more and more individuals opting to invest in securities through collective investment vehicles. As a consequence, the amount of funds under management has increased dramatically. The old prohibition ignored these developments and permitted clients to be held captive by circumstance. The flat rate paid can be significant, but is not necessarily related to the efforts of the investment adviser. Taking these factors into consideration, I believe that the Commission imposed conditions in the rule designed to protect investors from fraud while improving competition. We shall see how it works.

A second example that illustrates my comment about the complicated relationship between the regulated and the regulators is the current discussion about certain proposals to organize a self-regulatory organization for financial planners and thus impose an additional layer of regulation on the industry.

Much has been written recently about financial planners. In particular, the press has noted the exponential growth in the numbers of persons holding themselves out as financial planners. This growth, along with an increase in reports of abuses by some financial planners, has led some state officials, members of the industry itself, and others to call for increased regulation by the federal government and the states, creation of a new self-regulatory organization for financial planners, or some combination thereof.

The question has been raised as to whether most financial planners should already be registered with the Commission as investment advisers. After all, the definition of the term "investment adviser" in the Investment Advisers Act includes, with some limited exceptions, "any person who, for compensation, engages in the busir [illegible] of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." 10/ One could reasonably argue that a financial

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10/ Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. 80b-2(a)(11).

planner, in making recommendations to a client about how the client should allocate resources, must make some recommendation to the client about the advisability of investing in securities. I think that the Commission staff takes the position that if you engage in such activity you should be registered as an investment adviser. 11/ An exception might be, of course, if the financial planner is simply an insurance agent. Even then, there may be problems, since many insurance products are also securities within the meaning of the federal securities laws.

I imagine you are saying to yourself, that's all well and good, but what does it have to do with me? After all, most of you are not financial planners, you are investment advisers already registered with the Securities and Exchange Commission and with the states in which you do business. Why should you care one way or the other about proposals to regulate financial planners?

The answer is that the proposals may directly affect you as investment advisers. For example, the International Association for Financial Planning ("IAFP") has recommended the creation by statute of a self-regulatory organization for financial planners. The IAFP's statutory proposal would define the term "financial planning" as "providing to a natural person, for compensation, a

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11/ *See* Investment Advisers Act Release No. 770, 23 SEC Docket 556 (Aug. 13, 1981).

written plan recommending strategies and actions designed to help achieve the overall financial goals of that person on the basis of an evaluation of the personal and financial condition and capabilities of that person." 12/

I would guess that many of you, in addition to making securities recommendations or managing your client's securities portfolio, are from time to time called upon by your clients to make recommendations concerning the client's overall financial goals. For that reason, you may well find yourself covered by this legislation and required, if it were enacted into law, to join a self-regulatory organization. In fact, the IAFP's description of its proposal explicitly notes that the definition could cover persons who are not exclusively engaged in financial planning, such as insurance agents, brokers, bank employees, accountants <u>and</u> <u>investment</u> <u>advisers</u>. 13/ It should come as no surprise then that organizations like the Investment Company Institute, the American Institute of Certified Public Accountants, and the American Bankers Association have opposed the IAFP's proposal. So, we have a group that desires stricter regulation and professional t[illegible] at odds with the other members of the group who do not wish to be doubly regulated.

12/ Int'l Ass'n for Financial Planning, Financial Planner Self-Regulatory Organization 3 (Oct. 14, 1985) (unpublished memorandum).

13/ *Id.*

Moreover, all the hullabaloo over financial planners and the suggestion that the planners should have their own SRO has led others to consider whether all investment advisers, and not just those who also provide financial planning services, should be required to belong to an SRO. Currently, a task force of the National Association of Securities Dealers is reviewing whether the NASD should offer to serve as an SRO for investment advisers. The task force has twice recommended to the NASD's Board of Directors that they should act as an SRO for investment advisers. As of yet, the Board has taken no action. Nonetheless, the issues raised concerning the regulatory status of financial planners may have a major impact on the way you as investment advisers are regulated.

Now, having warned you that you need to be interested in proposals to set up a self-regulatory organization for financial planners and/or investment advisers, I suppose it's fair for me to tell you what I think of the idea. I believe that the idea of an SRO for investment advisers is one that deserves serious consideration, both by the Commission and by others. I must tell you, however, that, while I think that the IAFP concept deserves further study and is worth pursuing, I have several reservations about the specifics of the proposal. First, as you undoubtedly know, creating a new SRO would require Congressional action. My experience during the 20 months I have been a Commissioner, albeit limited, has shown me that getting legislation through Congress is almost inevitably long, arduous and unpredictable. I might add that the statute that Congress ultimately gives you may not look anything like the legislation you proposed in the first place.

In connection with my second point, I am sorely tempted to treat you to a discourse on my views of the efficiency, efficacy and sanity of self-regulatory organizations, but those views may be considered heretical. It is sufficient to note that our regulatory system is founded on the notion of self-regulation, a notion which 50 years ago and still today fits the structure of the securities industry. Perhaps even more important is the fact that, in today's environment of the shrinking federal budget, "self-regulation" is a notion that is particularly attractive from the SEC's point of view.

We at the Commission are faced with the dilemma of how to deal with ever-increasing regulatory responsibilities and obligations with diminishing (certainly on a relative scale) resources. I do not usually quote numbers or statistics because they can be manipulated and therefore be viewed as a suspect. Nevertheless, the simple facts that there were 4,400 registered investment advisers in 1982 and [illegible] today in 1986 the number has increased to 12,000 demonstrate the seriousness of the situation from a regulatory point of view. The staff has not grown 300%. An SRO of some sort for financial planners <u>and</u> investment advisers seems to be required if regulation of the industry is to be minimally effective in today's world.

If the Commission and Congress determine that an SRO is appropriate for investment advisers, one must remember that any regulatory move should avoid duplicating existing regulatory structures. There are many ways to avoid this, some more reasonable and cost-effective than others. However, I will leave a discussion of the alternatives for another day or speech.

The uncertainty surrounding this whole issue, I think, amply illustrates my opening remarks about the complexity of the relationship between government regulators and those whom we regulate. Here we have a group of persons, some of whom may consider themselves currently outside of the scope of the Commission's regulation, seeking to have themselves included within the regulatory framework of the federal securities laws. At the same time, other representatives of the financial planning industry, including the Institute of Certified Financial Planners, have expressed at least initial opposition to the idea of creating a separate SRO to which financial planners would be required to belong. I think this clearly demonstrates my point that the persons to be regulated often have diverse views as to the costs and benefits of government regulation, non-regulation or deregulation.

This diversity of views should also serve to remind each of you of the importance of giving the Commission your input on these and related issues, both individually and through industry groups like the ICI. It is only with the benefit of the insights provided by interested parties that the Commission can reach reasonable conclusions about the form regulation should take.

Thank you for your time and attention.